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BLACK MARKET AND SOUTH KOREAN TRADE PRACTICES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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BLACK MARKET AND SOUTH KOREAN TRADE PRACTICES

THURSDAY, OCTOBER 19, 1989

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT
OF GOVERNMENT MANAGEMENT,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:37 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin, Kohl, Lieberman, and Pryor.

Staff Present: Linda J. Gustitus, Staff Director and Chief Counsel; Jack Mitchell, Staff Investigator; Mary Berry Gerwin, Minority Staff Director and Chief Counsel to the Minority; Frankie de Vergie, Chief Clerk; Melinda Loftin, Majority Counsel, and Gary K. August, Intern.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Today the Oversight Subcommittee is examining the black market of U.S. goods which are imported duty-free into South Korea by the Department of Defense for the support of our U.S. troops and their dependents who are stationed there.

Based on allegations of widespread abuses, the Oversight Subcommittee late last year requested that GAO conduct an on-site review of these activities.

The GAO has found that there is an enormous flow into the Korean black market of goods sold in our military commissaries and exchanges, that our enforcement methods are inadequate to stop the black market, and that the black market costs us significantly in both dollars and morale.

We have also learned that South Korea's highly restrictive trade practices nourish the black market and that at the same time the black market eases the pressure on South Korean government to modify these practices, leaving South Korea with little real interest in shutting it down.

James Booth, Executive Vice President for the American Chamber of Commerce in Korea, said in a letter to our Subcommittee on this subject as follows:

> There is a direct relationship between the trade practices of the Korean government and the existence of the black market. South Korean government restrictive policies on consumer goods imports create the black market, and continue to nurture the environment in which it thrives. The existence of the black market provides access to restricted goods for a narrow spectrum of wealthy and influential

Koreans. I believe that this access is sufficient to serve as a pressure valve that moderates internal political pressure for broader market opening. Basically, it's economic discrimination. If you are affluent, you can buy it. If you are poor or middle class, you cannot.

It seems that even the Department of Defense is conflicted about trying to shut down this illegal activity. Although one hand of DoD directs a substantial amount of staff resources to investigating and prosecuting our GIs who participate in black market operations, another hand of DoD—the Army and the Air Force Exchange Service—actually profits from all goods sold through the exchange system, whether or not they end up in the black market.

The Air Force Office of Special Investigations, in a May 1988 report on black marketing activity at Osan Air Force Base, described the scope of the problem as follows: "Black marketing activity is rampant. The amount of money reportedly made by some black marketeers is staggering."

The report pointed out that it is "difficult to drum up support for an all-out initiative to effectively detect and suppress black marketing," because the high sales which result from such activity—and OSI is somewhat discreet in the way that they describe this—"causes hesitation on the part of the management of these facilities to fully cooperate. Truly having an impact on the rate of black marketing activity is thought to hurt sales and create havoc with the inventory, and no manager wants that result."

So the Air Force Office of Investigations' own report shows that conflict within our own people.

The wide variety of agricultural, consumer and high-value items coveted in the black market are imported duty-free into South Korea in accordance with the Status of Forces Agreement. Under the terms of that agreement, the United States is allowed to bring in duty-free goods for the benefit of our service people stationed over there, provided such items are not circulated in the South Korean economy.

The United States, therefore, in addition to sending our troops over there in the first place, assumes the responsibility for ensuring the integrity of the exchange and commissary systems.

According to the GAO, some 70,000 persons, mostly GIs and their families, are entitled to purchase and retain items sold in Korean military exchanges and commissaries. Exchanges principally carry department store-type merchandise, and commissaries principally carry groceries and cosmetics.

The problem is that so many of the items sold through the exchanges and commissaries are either completely unavailable in the South Korean economy and are therefore valuable to those who can obtain them for resale on the black market, or are items which are allowed into South Korea for sale, but are subject to high South Korean government tariffs and import taxes, which make their availability on the black market especially attractive. Even items that are marked up 100 percent or 200 percent on the black market may be cheaper than items legally imported into South Korea but subject to South Korea's import duties and taxes.

As GAO will testify, the volume of sales through our commissaries and exchanges in South Korea of certain items that are popular on the black market are unbelievable. We sell 170 pounds of rice

per year for every man, woman and child eligible to shop in our South Korean commissaries. The service-wide average for rice is 13 pounds. So in South Korea, the average man, woman and child who are buying in our commissaries are buying about 14 or 15 times as much rice as the persons who are buying in our commissaries in Europe.

If one person consumed 170 pounds of rice a year, that would be a little over 14 pounds of rice a month, or just under half a pound of rice a day. There would be little room in a person's diet for anything else but rice. And that would be for every day, 365 days a year. We also sell one brand of scotch in Korea in quantities 46 times as large as that sold in our European commissaries and exchange stores.

The pervasive nature of the black market creates a number of problems for the DoD and for American interests in South Korea. First, it is simply not fair to the overwhelming majority of our GIs and their families who are honest shoppers. Many products become unavailable in the exchanges and commissaries because they have been directed to the black market. That is not only an inconvenience, but it hurts morale.

Moreover, the black market ends up dictating some of the items that the commissaries and exchanges stock—rice, Spam, scotch, as we'll soon hear from the GAO. Take, for example, the huge commissary at Osan Air Force Base. We have been told by a meat merchant who services Osan that he supplies 70,000 pounds of oxtails per month to the Osan commissary—70,000 pounds a month. He sells oxtails to commissaries in other countries, and of course the sales figures don't come anywhere close to the Osan mark. It doesn't take much of an imagination to figure out what is driving those figures. Oxtails are a popular food in Korea.

Second, this system is not fair to the taxpayers. As our witnesses will testify, it is true that most items diverted to the black market are paid for, and a portion of the exchange stores' profits go to morale and recreational benefits for our U.S. service personnel. But because of our transportation subsidies and enforcement costs, taxpayers are losing money to the black market. The GAO will testify that the United States Government spent about $35 million in 1988 on administering supplies sold through our exchanges and commissaries in South Korea. They estimate that for every dollar spent in our exchanges and commissaries on items that go to the black market, we pay—or lose—14 cents.

Now, there is no clear estimate as to the overall dollar value of these items that end up in the black market. The producers of Spam are quoted in the Wall Street Journal earlier this month as estimating that in 1987, 80 percent of their product sold on Army bases in Korea ended up in the black market. Other estimates range from 25 to 50 percent of products overall. Taking a very conservative estimate, if only 20 percent of these items end up in the black market, using the 14 percent figure, we can estimate that the black market is directly costing U.S. taxpayers some $7 million a year—and I emphasize that is a conservative estimate. And that is only the direct cost.

Third and perhaps most important, it is not fair to American business. The popularity of many black market items proves that

there is a strong demand for U.S.-imported goods. Yet South Korea continues to pursue a highly restrictive trade policy on many agricultural and consumer goods popular on the black market. South Korean tariffs and taxes far exceed normal rates in other countries. Many items are not allowed in, even with such tariffs and taxes. The tariffs and taxes make the cost of U.S. imports so expensive that the black market price is still competitive.

Mr. Booth, Executive Vice President of the American Chamber of Commerce in Korea, responded to the Subcommittee's question on the impact of South Korea's restrictive trade practices on the black market as follows: "The environment in which the black market thrives is created by the Korean government's restriction of access of these U.S. products to the Korean market through legitimate business channels. The goods which sell in the black market are either prohibited from legitimate import by the Korean government or they are subject to exorbitant tariffs and taxes which escalates their price in the legitimate marketplace to the extent that a markup of 200 or 300 percent is possible in the black market system."

Mr. Booth goes on to say that "The goods that flow into the Korean economy through the black market should be freely importable by legitimate businesses at internationally accepted tariff rates."

"The real cure for the black market," he writes, "is opening the Korean market to imports through legitimate business channels."

We will hear from our witnesses today about the extent of the black market, the success or failure of our efforts to stop it, and South Korea's role in it. We will also discuss where we go from here. If our ration control and law enforcement efforts are unable to control black marketing, because the forces that support the black market are too strong and too pervasive, then it is time to consider alternatives to law enforcement. An obvious route is getting South Korea to open its doors to these high-demand consumer goods. We will hear from the U.S. Trade Representative's Office and the Department of Commerce on how that effort is going.

But another alternative would be to refuse to enforce the Status of Forces Agreement. We could simply eliminate the ration control system and allow eligible persons to buy all they want of whatever they want at prices that include all of our costs and then stock our stores accordingly.

To continue on as we are is giving ourselves a double whammy. We are spending money to prosecute our GIs to control—at the request of the South Koreans—a black market that South Korea causes. It is the South Korean trade practices which cause the black market in South Korea. We end up with a huge law enforcement cost, prosecuting our GIs and their families, and then they use the black market as a pressure valve to continue their restrictive trade practices against the importation of U.S. goods.

It is absolutely unthinkable to me that we are spending American taxpayers' dollars and spending perhaps 20 percent of our law enforcement time in South Korea to protect South Korea from the import of American products which their unfair trade practices are causing and not allowing to come in legally. I find that totally abhorrent and totally unacceptable.

We are protecting Korea from a black market of their own making and hurting ourselves in the process. Why should we do it? Today's hearing has been called to help answer that question.

I also want to thank Senator Kohl for being here.

Do you have an opening statement, Senator Kohl?

Senator KOHL. Thank you, Mr. Chairman.

I think you deserve to be commended highly for scheduling these hearings on such an important topic. I look forward to hearing from our distinguished panelists.

Senator LEVIN. Thank you, Senator Kohl.

Our first witnesses are representatives of the General Accounting Office: Donna Heivilin, Director for Logistics Issues, National Security and International Affairs Division, accompanied by Dick Helmer, Assistant Director, and Mark Little, Audit Manager of the Far East office.

Ms. Heivilin.

TESTIMONY OF DONNA M. HEIVILIN, DIRECTOR FOR LOGISTICS ISSUES, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE,[1] ACCOMPANIED BY DICK HELMER, ASSISTANT DIRECTOR, NSIAD, AND MARK LITTLE, AUDIT MANAGER, FAR EAST OFFICE

Ms. HEIVILIN. Thank you, Mr. Chairman, members of the subcommittee.

We are pleased to be here today to discuss the results of our review of the black market activities in South Korea. This morning we will describe the causes for and the magnitude of the black market problem, the system that the U.S. Forces Korea Command uses to control black marketing, or its attempt to control it, and the cost to the U.S. taxpayer of black marketing U.S.-provided goods.

As you pointed out, black marketing is the act of transferring duty-free goods sold in the commissaries, base exchanges and other retail outlets to unauthorized individuals for profit and personal gain.

We know that black marketing of the duty-free goods is taking place, and we believe that it is widespread throughout South Korea. However, we are unable to determine how much of the goods are making their way to the black market. We saw goods from the retail exchange system that the U.S. military forces run in Korea in the Korean markets and stores. Also, we analyzed sales rates for selected items which indicate that the authorized consumers—our authorized military, civilians and their dependents—could not be consuming all of the merchandise sold. In addition, we discussed investigative case files and analyses with U.S. enforcement groups. These discussions indicate that the problem is widespread.

The ration control system costs about $12.1 million per year, and has weaknesses that make it more of an inconvenience to honest shoppers than a hindrance to black marketeers. Moreover, as a result of the black marketing, honest shoppers often cannot buy the merchandise that they want when they want it. It costs the

[1] See p. 43 for Ms. Heivilin's prepared statement.

U.S. taxpayer at least 14 cents for every dollar of merchandise that is black marketed. Neither the U.S. Government nor the Korean government have aggressively or effectively dealt with the black marketing problem.

Under the Status of Forces Agreement with South Korea, U.S. personnel and other specified individuals are entitled to purchase items from the U.S. Forces Korea retail outlets such as the commissaries and base exchanges. These outlets are not subject to Korean taxes. In return for this purchasing privilege, authorized consumers are obligated not to sell or transfer these duty-free items to others who are not authorized to receive them.

The U.S. armed forces, in cooperation with the Korean government, are required under the Agreement to take steps necessary to prevent abuse of this privilege. However, both governments have criticized each other from time to time for not doing enough to solve the problem.

On the U.S. side, the Government has criticized the Koreans for not cracking down on black marketeers and for not easing trade barriers on U.S.-made products. The Koreans have said that the U.S. is not doing enough to control black marketing of U.S. goods. They say black market is a U.S. problem.

In addition to law enforcement, many U.S. officials believe the key to deterring black market activities is for the South Korean government to lift trade restrictions and lower tariffs on U.S. and other foreign products. U.S. officials believe that eliminating the trade barriers and lowering tariffs would result in a corresponding increase of U.S. and other foreign products into Korea. Consequently, the demand for items from the U.S. military bases would decrease.

The 1988 tariffs on some U.S.-made items are high. The tariff on beer, wine and whiskey is 100 percent; on large appliances, such as refrigerators, washing machines and music systems, it is about 30 percent. According to the Korean Ministry of Finance, tariffs are scheduled to decrease between now and 1993.

The U.S. Forces Korea's ration control system has three objectives: one, to fulfill U.S. obligations under the Status of Forces Agreement; two, to ensure that adequate supplies of goods are available to meet the authorized consumers' needs, and three, to deter black market activities.

Chart 1 shows two of the controls that are in place to accomplish these objectives.[1] First, the monetary monthly limits and second the monthly quantity limits. As you can see, a single GI in Korea can spend up to $500 in the system each month. If he or she has a family consisting of a spouse and one child, a family of three, the family can buy up to $800 of merchandise per month. The limits we have shown here are quantity limits for alcoholic beverages and cigarettes. A single GI can buy four units of alcohol per month. A unit in this case would be a case of beer or a bottle of liquor, usually, a one-liter bottle.

Additionally, some items are specifically controlled, such as refrigerators and televisions; lower graded or lower ranked personnel

[1] See charts on p. 53, following Ms. Heivilin's prepared statement.

have to have special permission to buy them. And store shelf limits are placed on quantities that can be purchased at any one time for certain items.

For example, one 25-pound bag of rice can be purchased at a time; three cans of Spam; and one package of chicken drumsticks. We have examples of some of the things here on the table. We got them from the commissary and exchange at Cameron Station in Virginia. It provided them to us to display at the hearing, but they could not provide us a 25-pound bag of rice because they are not sold in the commissaries or exchanges here. The largest bag the commissary could provide was a 20-pound bag, which we have on the table.

It is not difficult to spot the signs of black marketing. Large numbers of Korean markets and stores sell duty-free items. Many of the items still have price stickers from our exchange systems on them. When you peel back the Korean label, you will frequently find the exchange label or the commissary label.

One such market is Namdaemun. It is one of several shopping areas in Seoul where there are large numbers of individual shops selling U.S. Forces Korea duty-free goods side-by-side with Korean products.

There are "hawkers" on the streets of Itaewon, a shopping area near the Yongsan Army Garrison in Seoul, who sell duty-free goods including American light beer and wine. They'll also take orders from people on the street, and will come back a few hours later with whatever was ordered.

Senator LEVIN. It is an open black market is what you are saying.

Ms. HEIVILIN. Yes, an open black market.

Some Korean appliance stores sell a variety of American appliances. In one of the stores we visited, a General Electric refrigerator still had the exchange sticker on its shipping carton.

While we are not able to precisely measure the magnitude of black marketing, current sales rates for some items popular on the Korean economy, such as rice, Spam, hot dogs, cheese and hair spray, indicate the magnitude of this problem to some degree.

The chart we are showing you now shows that the sales rates for these items are much higher than authorized consumers would normally consume. We saw large amounts of these items being sold on the black market.

Senator LEVIN. Is that per year?

Ms. HEIVILIN. Yes, this is per authorized consumer per year. We calculated, 70,321 authorized consumers, but they are not all likely consumers because our figure includes 37,428 military members who have no dependents in Korea. If we extracted the number of military members who ate their meals in base dining facilities and, therefore, were not likely to consume these kinds of items, or as much of these items that we are seeing here, the per capita sales rates would be higher.

Our total of authorized consumers also includes 3,569 children under 3 years of age, and they are not likely to consume large quantities of the items we show on the chart.

Scotch whisky is also very popular among the Koreans, as you pointed out, and Chivas Regal is one of the most popular brands. It

is prevalent on the black market, and it is the number one selling liquor at the Class Six stores.

The sales of Chivas Regal were very high given the number of authorized buyers. The chart we have here shows our comparison of overall sales of Chivas Regal and the number of active-duty military in South Korea to the Chivas Regal sales and the number of active-duty military in Europe. On a per capita basis, 46 times more liters were sold in South Korea than in Europe.

The Cameron Station exchange was kind enough to loan us this bottle of 12 year-old Chivas Regal Scotch. However, it could not provide us a bottle of the 21 year-old Chevas Royal Salute Scotch. The exchanges didn't have it in any of their Class Six stores in the metropolitan Washington, D.C. area. We had to go downtown and buy it. We called around to three different liquor stores and none of them had it. We had to special order it from one of the stores.

Mr. HELMER. I think it is important to note that the Royal Salute sold for $65 a bottle in Korea. It is a three-quarter-liter bottle. There aren't too many GIs that we found over there who can afford to drink it even though 25,680 bottles were sold.

Also, the 12-year old Chivas Regal sold almost 315,000 bottles. We weren't able to find too many GIs who drink this, either.

Senator LEVIN. Your chart compares the per capita purchase in Korea compared to the per capita purchase in Europe, is that right?

Mr. HELMER. That's correct, for active-duty military.

Senator LEVIN. For active-duty. In Korea, it is almost 7 liters; in Europe, it is one-sixth of a liter.

Mr. HELMER. Yes.

Ms. HEIVILIN. That's correct.

Mr. HELMER. If you include both scotches in those computations, it comes up to a little over 8 liters in Korea, and it barely affects the rate in Europe.

Senator LEVIN. So the bottom line is that about 50 times as much scotch is bought by military people in Korea as is bought in Europe.

Ms. HEIVILIN. Chivas Regal Scotch.

Senator LEVIN. Of that particular brand.

Mr. HELMER. Yes.

Senator LEVIN. Fifty times as much.

Ms. HEIVILIN. That's right.

Mr. HELMER. It is also interesting to note that a gentleman by the name of Frank Hill, who was the area manager for the Class Six stores in Korea which sell the scotch, pointed out to us on our first visit that in his opinion Chivas Regal Scotch is the biggest black market item in Korea. He said he wouldn't be surprised if just about all of it that was sold ended up in the black market. He was an employee of U.S. Forces Korea, which at the time ran the Class Six stores.

Ms. HEIVILIN. That wouldn't be surprising if what I described earlier were true, and the fact that you can't even get the Royal Salute in the Class Six stores around here. We have probably the highest population of military who could afford to drink scotch that was that expensive in this particular locality, and we're finding it is not even being sold in the Class Six stores.

The next chart that we have shows that the Army and Air Force Exchange Service 1988 shipments of some items to Korea, for example, toasters and television sets, were also very high. There are a number of schemes used by the marketeers to acquire these items and other merchandise. The schemes generally fall into two groups. One group circumvents or works outside the ration control system, and the other works within the established system of controls.

The schemes for circumventing or working outside the ration control system to purchase duty-free items includes racetracking, using cashiers and clerks as accomplices, diverting items from the warehouse or showroom, or using fraudulent or altered ration control documents.

We have a picture of some of the items that we saw in black market areas in Korea. The colored pictures were taken at the Second Infantry Division at Camp Casey, a black market area outside of the gates; and the black and white pictures were taken in Namdaemun, the underground black market area in Seoul.

Mr. HELMER. Chivas Regal, Corning Visionware dish sets—35,079 sold——

Senator LEVIN. For how many people eligible to buy it?

Mr. HELMER. Well, if you take the universe, it is a little over 70,000, but we only have about 10,000 families, so on that basis it is about 3½ per family. We also had 49,000 of these irons sold——

Senator LEVIN. For 10,000 families?

Mr. HELMER. Yes, sir.

Ms. HEIVILIN. Seventy thousand eligible people, right. Everybody who can iron buys these irons.

Senator LEVIN. Yes. Senator Lieberman says they are very neat people over there.

Ms. HEIVILIN. Yes, they're doing a lot of ironing in Korea. [Laughter.]

Mr. HELMER. It is interesting to note on these pictures taken at two black markets that, for example, we have Levis jeans here with the exchange stickers still on them; the Chivas Regal with the Class Six stickers; all the various items sold in the military stores; the smaller bags of rice; all the various liquors we sell; hair spray, which is a big item, 32 cans for every female, including children under 3 years of age. Just about every item sold in the stores is a black market item.

Ms. HEIVILIN. Racetracking, which is one of the ways these items are procured for black marketing in Korea, is when a purchaser makes multiple daily purchases from the same or different retail facilities, always keeping the total dollar value of each purchase under $5. Five dollars is the limit at which procurements are tracked by the ration control system. This avoids it being recorded in the ration control system, or they may be doing it to circumvent shelf limits on items with high demand rates.

We have some pictures of shelves with item limits displayed on them that we can have you look at if you would like to. For example one picture shows the oxtails and a purchase limit of one package.

In some locations, racetracking is made easier by the retail outlets' location and stockage policy. For example, at Yonsan Army

Garrison in Seoul, the exchange operates two convenience stores side-by-side, and both sell similar products that are in demand on the black market, such as hot dogs and American cheese. This makes it easier for shoppers to go from one store to another.

Another typical black market operation uses cashiers and clerks who work as accomplices with shoppers and either record a purchase amount less than the actual total or record the amount properly, but hide the sales card and destroy it later.

Diversion involves the removal of duty-free items from the retail outlet by employees, usually Korean nationals, for their own use or resale to black marketeers. Usually, the diverted items end up on the black market, although the employee diverting the items normally pays for them and rings up the retail selling price in the store's cash register. It appears like the item was sold legitimately and that no crime was committed. This reduces the chance of generating criminal investigations.

Using fraudulent and altered ration control documents to purchase high-value items is common. In this scheme, either fraudulent ration control plates are used to make the purchase, or the purchaser's actual plate is used and the sales cards are removed from the system.

We have a picture here of fraudulent cards. They don't do too bad of a job of counterfeiting them; however, there are some typos and misspelled words if you look closely. The real one is at the bottom—Dick is pointing to the real one right now—the fraudulent one is at the top, not quite as clear. The fraudulent one has some typos and some misspelled words.

On the I.D. card, the real one is at the top. On the bottom one you can see the picture of the lady with her name just printed on the board under her face. On a real card, you would have the names made of plastic letters that are inserted in the board.

The next chart shows purchases of high-value items made using fraudulent ration control plates. Chart 6 shows that 438, or 5.4 percent of 8,186 items purchased, were made using fraudulent plates. Chart 7 shows purchases of certain brand name items using fraudulent plates. As you can see, we have General Electric washers and refrigerators; Sony and Pioneer televisions; Magic Chef ranges; and other items. So it is primarily large appliances that are purchased with fraudulent plates. The purchases using fraudulent plates range from 5.8 to 38.9 percent of the total units purchased.

The cost of the black marketing can be viewed from 2 perspectives—cost to the U.S. government and the taxpayer, and the cost to the morale of the honest shopper.

Total sales in Korea for U.S. commissaries, exchange stores, Class Six outlets, and other retail facilities was $250.4 million during fiscal year 1988, as shown on Chart 8.

While the portion of the sales for the black market activities cannot be determined, the estimated appropriated funds support for all sales during fiscal year 1988 was about $35.6 million. Of this amount, about $12 million was for ration control; $17.3 million for the transportation cost, and $6.3 million for civilian and military salaries, and the remainder for operations and maintenance costs.

We estimate that for every dollar spent in the U.S. Forces Korea retail outlets on items for the black market, the American taxpayer pays about 14 cents in taxes to support these black marketeers.

In addition to the financial costs to the government, honest authorized consumers have also experienced anger and frustration. They must cope with a system they know is ineffective in deterring black marketeers. The black market is evident on a daily basis as racetrackers work over the U.S. Forces Korea retail system. Some authorized consumers told us that often the items they want to buy are not available due to the black market demand. And in addition, the retail outlets tend to overstock items that are in demand on the Korean economy, using shelf space that could be used for other items wanted by the authorized consumers.

These same authorized consumers believe that the Korean authorities are not concerned with Korean abusers of the system and, therefore, that these abusers, who are outside of U.S. jurisdiction, are not being punished. They see black marketing as a moral issue more than a dollar-and-cents issue, and even if there were no costs at all to the U.S. government, these consumers would like to see the black marketing stopped simply because it is wrong.

Mr. Chairman, that concludes my prepared statement. I have a longer statement I would like to submit for the record, and we will be happy to respond to questions.

Senator LEVIN. Ms. Heivilin, we are grateful to you for your testimony and for all the hard work which you and your colleagues at the GAO have put into this. In a way, it is a complicated issue, but it is also very simple. When you boil it down, it seems to me we have this. We are there in Korea protecting Korea and protecting our interests in Korea. Surely the Korean government wants us to stay. As a matter of fact, the President of South Korea just yesterday was saying he doesn't want any of our troops to leave. Their struggle is to keep us there.

Then they have these unfair trade practices. They don't allow our products in freely. You can't freely export these products to South Korea, or there would not be a black market; is that correct?

Ms. HEIVILIN. That's true.

Senator LEVIN. So their restrictive trade practices create a black market.

Then the onus is on us to try to stop it. So we are laying out taxpayer dollars, and God knows how much time, to try to stop something that their unfair trade practices have created. Now, I find that very, very disturbing. It is an element of our presence there which has not really been brought to light adequately at all.

I'm not sure what the answer is. I think we've got to move in one of two directions—which are inconsistent directions. One is to enforce the sale and resale prohibitions better; the other one is to quit enforcing them altogether. We could have a price at a wholesale outlet which includes all of our costs, and ship all the items to Korea that anybody wants to buy and use it as an outlet for American products. That is kind of a novel approach, but it is an approach.

I take it you agree, Ms. Heivilin, with the Air Force Special Investigations Office that black marketing is rampant in South Korea——

Ms. HEIVILIN. Yes.

Senator LEVIN [continuing]. That it is open——

Ms. HEIVILIN. Yes.

Senator LEVIN [continuing]. Which means that if the South Korean government wanted to end the outlets, they could do so, since those outlets are out there in the open, selling items that they have not paid duty on. Is that correct?

Ms. HEIVILIN. They do not close them down; that's correct.

Senator LEVIN. So, regardless of what the South Korean government says, is it not fair to say that they allow an open black market?

Ms. HEIVILIN. Yes.

Senator LEVIN. Okay. Apparently, some South Koreans say that the black marketing is a U.S. problem; yet both you and the Armed Forces Korea have stated that South Korean black marketeers lure U.S. service personnel and their dependents into black marketing activities.

What percentage of black marketing activities, do you estimate, do not involve at some point in the transaction a South Korean national?

Ms. HEIVILIN. All of the black marketing activities involve a Korean national.

Senator LEVIN. What is the basis, then, for South Korea or South Korean representatives to say that ending the black market is a U.S. problem if South Korean nationals are involved in all the transactions? Is it not true that this is principally a problem which their trade practices not only create but which South Korean nationals are always involved in?

Ms. HEIVILIN. Well, they don't seem to see it as a criminal offense. They see it as a customs offense, and they don't see that as serious.

Senator LEVIN. But they don't enforce that customs law, do they?

Ms. HEIVILIN. They seem to go after high-dollar-value customs offenses, but that's not the kinds of items we are discussing today that go out of the exchanges and commissaries. They look more at large-volume items that are sent through the mails to be sold.

Senator LEVIN. Let me, then, rephrase my question. Would you agree that it is not only their unfair trade practices which have created this black market, but that they rarely take action to stop the open black market and that South Korean nationals are always involved in these transactions?

Ms. HEIVILIN. That's correct.

Senator LEVIN. So they both created the problem and take almost no steps to solve the problem.

Ms. HEIVILIN. Their trade practices create the problem, and they take almost no steps to stop the practice, yes.

Senator LEVIN. Now, the other alternative—there are two alternatives. One is to try to enforce this complicated system of rationing and rules that we've got that plunge us into all kinds of bureaucracy and law enforcement to do a better job of trying to protect South Korea from the black market of their own creation. That's one route, and we'll call that route number one. To do a better job, we could reduce the ration limits. Are they too high? If

we want to really enforce this law and make it effective, should we not lower the ration limits?

Ms. HEIVILIN. They probably could be lowered, yes.

Senator LEVIN. Did those limits go up recently? Did they go up from $2 to $5 in July?

Ms. HEIVILIN. Well, the limits are the dollar volume——

Senator LEVIN. I'm sorry, I've confused you. Was the rule about recordkeeping changed in July so that we must keep a record of purchases that are above $5 rather than the prior limit which was $2 for recordkeeping of purchases?

Mr. HELMER. It was $1, and it went up to $5 in July of 1987. But we do feel that the ration limits are extremely high. They also went up at the same time, and for example, a single military member's monthly purchase allowance in dollars went up from $256 to $500, and U.S. Forces Korea could not provide us with any valid reason why those were raised.

Senator LEVIN. Now, the people who buy up to $500 a month are people who eat in the mess hall, aren't they?

Mr. HELMER. In many cases, they are. There are about 39,000 of those people who are single who also can get all their meals in dining facilities. And as we point out in our statement, last year there were over 19 million meals served in the dining facilities in South Korea.

Senator LEVIN. So that two things have happened, and I think I have confused it in terms of our rules. One is we have raised the limit for how much you can buy a month——

Mr. HELMER. Yes.

Senator LEVIN [continuing]. In order to try to protect Korea, again, from this black market that they have created. The other thing that we did, though, is apparently we lowered the recording of purchases in July from $5 to $2; is that correct?

Mr. HELMER. Well——

Senator LEVIN. There are two different issues. One is how much you can buy, and the other one is what we record?

Ms. HEIVILIN. Right.

Senator LEVIN. Tell me what is the level of each individual purchase that we record. What is the dollar level?

Mr. HELMER. I'd like to explain that to you a little bit. In July of 1987, that limit was $1 so that any purchase above $1 had to be recorded in the system. In July of 1987, they raised that to $5 so that any purchases under $5 did not have to be recorded. It resulted in rampant racetracking where we had Korean dependent wives making $500, $600, $700 per day by going from one store to another and buying under $5 during each purchase and then black marketing the items.

Now, as a result of our audit, U.S. Forces Korea has now lowered the amount to $2.

Senator LEVIN. So it went from $1 up to $5 and then back to $2?

Mr. HELMER. Back down to $2 recently, yes.

Senator LEVIN. Okay.

Ms. HEIVILIN. We should point out, however, that the $5 limit or the $2 limit, whatever it is, only creates the control if in fact it is recorded. And we found a variation in the numbers of these pur-

chases that were recorded into the system. In some exchanges, we found as little as 11 percent of the purchases were being recorded.

Senator LEVIN. And if they are not recorded, then the $500 cannot be enforced; is that the point?

Ms. HEIVILIN. Yes. It doesn't go into the system so you have a number going in, adding to the monthly calculation that would add up to their $500 limit.

Senator LEVIN. The way they enforce the $500 recording each purchase?

Ms. HEIVILIN. Right.

Senator LEVIN. Above a certain amount.

Ms. HEIVILIN. Right.

Mr. HELMER. No; they record every purchase——

Senator LEVIN. Whether or not it is above a certain amount.

Mr. HELMER. Well, they record every purchase right now above $2—at least, they are supposed to. But one of the major problems we found is that in many cases the shopper is in collusion with the black marketeer, like at the Osan Air Base case, and they just don't bother to record the purchases, and then the black marketeers split their profits with the cashiers.

Ms. HEIVILIN. They basically take this plate, which is a ration control plate kind of like your charge card plate, and do what they call "anvilling"—that is, make an impression of it—and put the amount of the purchase on it. The sales record is supposed to go into their ration control system. But frequently it is just thrown away, or it is left to be thrown away later—it disappears.

Senator LEVIN. But that is the mechanism to enforce the $500 rule?

Ms. HEIVILIN. Right.

Mr. HELMER. Yes.

Senator LEVIN. Okay. An AAFES security official who had served recently in South Korea told the Subcommittee that the AAFES command actively resisted and discouraged black marketing enforcement efforts. This investigator stated that AAFES officials felt black marketing enforcement had a negative effect on sales, with the result that there would be a negative effect on profits, and part of those profits are used for the morale, welfare and recreation fund. He said that there was constant pressure from his superiors not to press black market investigations for fear that they would cut into those profits.

What did AAFES officials tell you about their attitude toward black marketing enforcement?

Mr. HELMER. When I was in Korea in February of this year, I met with Colonel Herzog, who was the head of AAFES in Korea. Colonel Herzog made no bones about it. In his view, black marketing is a victimless crime. It is victimless in his opinion, even though the American taxpayers spend 14 cents on the dollar for transportation for every dollar of goods that is black marketed, the profits from such sales go into the morale, welfare and recreation funds, and one would offset the other. He made it very clear that black marketing and its control was at the very bottom of his list of priorities.

Senator LEVIN. What about all the law enforcement time; did he comment on that at all?

Mr. HELMER. No, he didn't, and I must say in all candor that he did not have a very good relationship with the criminal investigators, especially the Army Criminal Investigations Division. On one hand, he is selling great volumes of these items that are going to the black market; on the other hand the investigators have to try and stop it after it is already in the black market, and it just doesn't work that way.

Senator LEVIN. So is it fair to say on the one hand that fund is profiting from sales; on the other hand, we've got investigators who are trying to stop those sales?

Mr. HELMER. That's exactly true.

Senator LEVIN. And spend a reasonable percentage of their time doing it—I think we have heard as much as 20 percent——

Ms. HEIVILIN. About 20 percent.

Senator LEVIN [continuing]. Of our law enforcement time is spent trying to stop a practice from which we profit—or from which we as a country don't profit, but which that morale fund profits.

Mr. HELMER. Yes. And I think it is interesting to note also the criminal investigators told us they could spend 100 percent of their time on black market cases.

Ms. HEIVILIN. Mr. Chairman, we believe that if we are going to be trying to control black marketing in Korea that we should be thinking about ways to motivate the store managers, ways in addition to the profit motivation that is now in place. That AAFES manager should take some responsibility for controlling the black marketing, because after all much of what they sell is black marketed.

Senator LEVIN. I gather, then, that AAFES does not have a direct self-interest in limiting the black market—or do they?

Ms. HEIVILIN. No, they do not.

Mr. HELMER. In fact, they have the other incentive because they are profit-motivated, and sales are their business.

Senator LEVIN. Thank you again. This has been a lot of work on your part, and we are very appreciative of it. We may have additional questions for the record.

The next panel will be Colonel William Hughes of the U.S. Army, who is with the U.S. Forces in Korea, and we have the Army and Air Force Exchange Service in the Pacific represented by Colonel James Donahoe of the Air Force.

Gentlemen, we are grateful for your presence. We have a lively subject here.

Colonel Hughes, do you want to start off?

TESTIMONY OF COL. WILLIAM D. HUGHES, U.S. ARMY, U.S. FORCES KOREA[1]

Colonel Hughes. Yes, Mr. Chairman, thank you.

I appreciate the opportunity to discuss efforts by United States Forces Korea to combat black marketing. Ration control exists to combat black marketing for two significant reasons. First, we are committed to honor our obligations under the ROK-U.S. SOFA Agreement. Second, and equally important, we have an inherent

[1] See p. 61 for Colonel Hughes prepared statement.

responsibility to DoD personnel in Korea to provide a wide variety of U.S. goods, to maintain a high quality of life and morale of our armed forces in the ROK.

The General Accounting Office's review of black marketing activities in Korea was very useful to us as we fine-tune our ration control system. We are continually looking for ways to improve the system while maintaining a good quality of life for all.

I will discuss black marketing in Korea and explain the current ration control system designed to assist the command in deterring black marketing by its members. I will briefly discuss costs for the ration control system, as well as highlight recent initiatives to improve the command's effort against black marketing.

I will also provide a brief plan for ration control in the future.

Our comments on GAO observations during their review of black marketing activities in Korea are included in our statement for the record, sir.

The black market exists in Korea for several reasons, including high Korean taxes, high demand for foreign goods, particularly U.S. goods, and protective limitations on imports.

We do not condone black marketing, and we attempt to deter it by establishing the monthly purchasing limits that have been described previously. They include dollar ceilings as well as quantity limits on alcohol and cigarettes. Records are maintained on high-value items purchased, and they may be used by commanders to ensure individuals maintain accountability for those items. Daily shelf limits are imposed on products that are popular on the black market. Joint criminal investigation command and military police black market investigative teams operate throughout the command, handling over 200 cases per year.

Both the Army Criminal Investigation Command and Air Force Office of Special Investigations conduct covert and overt operations. They concentrate primarily on organized black market rings. Publicity on individuals being caught and punished is also part of our deterrence program. J1 Data Management, the office primarily responsible for the ration control program, provides commanders with reports indicating high-value purchases made by their personnel. J1 Data Management also provides law enforcement agencies with reports which indicate individuals who have purchased numerous high-value items such as televisions or video-cassette recorders.

The law enforcement agencies work together to deter black marketing in Korea. Historically, ration control has been accomplished by manual methods; but, in 1971 we moved to a semi-automated system which was last upgraded in 1984. The current system includes the issue of a credit card-type ration control plate, which entitles the bearer to enter and purchase reasonable quantities of duty-free goods in either the commissary or exchange stores.

Our current system relies on the store manager, the entrance checker, the cashiers, commanders, and of course, each ration control plate-holder, to help keep the system operating honestly.

Law enforcement agencies involved in identifying violators include the U.S. Army Criminal Investigation Command, the U.S. Air Force Office of Special Investigations, the Provost Marshal, and security police.

Cost estimates for the ration control system were provided to Congressmen Leath and Martin in August of 1988. We reported the total cost for operating the ration control system at $13,026,805 for 1987. These costs are divided into two parts. There are direct costs and there are indirect costs. The direct costs were $3,664,000, and they provide the supplies and equipment for the current system as well as the personnel to operate the system. The indirect costs, though, of $9.4 million are not a funded cost. They are our estimate of the dollars related to the time it takes for individual service members to complete the administrative requirements of the system. They also include commanders and clerical time.

Elimination of the ration control system would save these individuals time, but it would not eliminate their positions. Total OMA funds directly related to ration control are approximately $1 million per year.

We have recently undertaken several initiatives to reduce black marketing and to re-emphasize ration control procedures. First, we have, as indicated, reduced the minimum amount of sale for recording purposes from $5 to $2. Second, we have published expected levels of administrative sanctions to be imposed for violating ration control limits. Third, the command policy has been changed for the inventory of high-value items purchased by DoD personnel. Fourth, retail facility managers have been instructed to comply with the requirement to check the lost/stolen ration control plate report, and they will be informed of those clerks who make sales using lost, stolen or counterfeit cards. Lastly, our installation commanders were instructed recently to ensure that they comply with the requirement to forward sales cards to J1 Data Management so that reports can be prepared and forwarded to commanders in a timely manner.

We are looking to a future ration control system that will capture sales data at the point of sale. Initially, we are considering a point of sale system similar to that which was funded and is being installed now for Southern Command in Panama. We are planning for this system to screen and identify lost, stolen and counterfeit cards and to preclude purchase with those cards.

The proposed system would be able to identify violators the day after a violation occurs. It would also be able to identify individuals or families that are purchasing well above their family needs. For example, our ration control system limits purchases to six items in the commissaries unless a more restrictive shelf limit has been imposed. An individual who is purchasing for the purpose of resale on the black market could purchase up to 162 bottles of shampoo a month if they shopped at the commissary once a day. The planned system would identify individuals with unreasonable purchasing habits.

In summary, we are very serious about controlling black marketing. To do this requires a ration control system that is as convenient as possible while still achieving the primary objective of controlling duty-free goods. A new version of an automated ration control system that captures data at the point of sale and electronically forwards that data, especially by the end of the work day, would be extremely effective in combatting black marketing. Until it becomes unprofitable to purchase products sold at U.S.F.K. facilities

for resale on the black market, we believe that a ration control system will be necessary to meet our obligations to control duty-free goods.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to your questions.

Senator LEVIN. Thank you, Colonel Hughes, very much.

Colonel Donahoe?

TESTIMONY OF COL. JAMES B. DONAHOE, U.S. AIR FORCE, REPRESENTING ARMY AND AIR FORCE EXCHANGE SERVICE—PACIFIC [1]

Colonel DONAHOE. Thank you, sir.

Mr. Chairman, I really appreciate this opportunity to come here today and discuss an item that is very important to the Army and Air Force Exchange Service, better-known as AAFES.

I am Jim Donahoe, and I am the Commander responsible for all of the Army and Air Force PXs and BXs in the Pacific Basin. That includes Korea. We are the largest single retail organization on the military installations in Korea. We have retail sales of about $150 million a year. We serve about 67,000 customers, and that equates to a per capita spending of about $186 per month.

What I'd like to try to do at this point is to put the exchange sales in their proper perspective.

First of all, the exchange is a nonappropriated fund activity. That means it must be nearly self-supporting. So in the price of the merchandise itself, we recoup all of the costs associated with buying the goods, paying the employee salaries, administrative overhead, in-country warehousing, distribution, and even the in-theater transportation.

We do use appropriated funds to transport American manufactured products from the continental United States to our warehouses in Korea, and when the goods are diverted to the black market, that does become a cost to the U.S. taxpayer.

But that transportation subsidy has been authorized by Congress for two reasons: it keeps the GIs buying American products rather than spending dollars in an overseas economy, and it also avoids a financial penalty for our service members overseas.

For example, the transportation subsidy allows us to sell products to our service members overseas at exactly the same price that they would pay in a Stateside PX.

Now, we do generate a profit from the sale of that merchandise, and that profit equates to about 4 percent of sales. We then use half of those profits to support our MWR programs—such items as gymnasiums, libraries, child care centers, sports programs. If the exchange were not there to provide that income, then the cost of operating those facilities would have to be borne by the taxpayers.

The other half of the earnings we use to improve our facilities and therefore improve our services to the military customers.

Now, like any business, we measure our operation in sales and earnings. But by far the most important part of our mission is cus-

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[1] See p. 86 for Colonel Donahoe's prepared statement.

tomer service and improving the quality of life for service members overseas and in particular in Korea.

The answer is simple. The payback is in higher retention and higher morale. And if we can contribute to higher retention, then there are less taxpayer dollars that have to be used for recruiting and retaining replacements.

So to offset the hardships of living in a foreign culture and often a hostile environment, we try to make our stores look, feel and operate just exactly like their Stateside counterparts, to give those stores and our people that "taste of home".

Unfortunately, a very small number of people do violate the Korean customs laws and have driven development of extensive ration control procedures. These procedures do affect our level of customer service.

At this point, I'd like under the umbrella of black marketing to give you two definitions. One is diversion. Under diversion, it is normally our employee who surreptitiously takes the merchandise out of the exchange. And historically in Korea, they have put the proper amount of money in the cash register. What they do is they then pocket as profit the difference between the PX price and what they manage to sell it for to an unauthorized individual off-base.

Such acts, diversion, violate our Status of Forces Agreement as well as the Korean customs laws, and we have devoted extensive efforts in trying to combat and stop this operation.

For example, we have a Merchandise Security Office, manned with 10 detectives, whose primary function is to look for diversion and other illegal transfers of merchandise. The cost of operating the Merchandise Security Office is $310,000 per year, and it is borne by our customers, not the taxpayer.

We are also in daily coordination with the Army's Criminal Investigation Division, the Air Force Office of Special Investigations, and the Naval Investigative Service in trying to detect and stop these operations.

The Government of Korea, however, views this as a victimless crime if theft is not involved. Recently, however, they have levied heavy fines for violations of customs duties.

Under the most common definition of black marketing, the customer buys the merchandise from the PX and then sells it to an unauthorized individual off-base. Admittedly, some of our employees have been in collusion with the customers to avoid ration control, and when we find this, we immediately begin the separation process.

We have instituted extensive procedures in our stores to limit the sale of merchandise that is popular on the black market. What I'd like to do at this point is say that you are one of our military customers coming through with a cart of merchandise and just show you the procedures that we go through with every customer.

The first thing we do is check your military I.D. card, and then check your ration control plate, which you saw on the GAO cards, right there. This plate gives us your name, and it also identifies your shopping privileges.

We then check our list to see if it is lost, stolen or reported as counterfeit.

We then check the categories of merchandise that you are authorized to purchase. So if you do not have a baby in your house and a "B" on your card, we cannot and will not sell you such things as baby formula, diapers, shampoo, et cetera.

We then look to see if you have any alcohol or cigarettes, and what we do is we fill out a form similar to a credit card voucher, record each of those individually, and anvil it or stamp it with your ration plate.

We then look to see if you have any high-value items, such as TVs, VCRs, down to the point of crock pots or even rice cookers. If you do, we record those on a separate form, individually by item, and stamp it with your ration control plate.

We then look to see if you have any special interest items. That is any item over $50—compact disks, cases of audio or videotapes, et cetera. If you do, we record those individually, and again with your ration control plate.

Then we check to make sure that you haven't exceeded any of the shelf limits. Local commanders can set the shelf limits in each store. That limits the number of items of any one selection that you can buy per visit. Normally, that limit is two cans of hair spray in a visit to any one of our facilities.

Then we record the total amount of your sale, and that applies to your monthly limits. And as you saw on the GAO chart, a family with two children has a total of $900 that they can spend between the commissary and exchange each month.

We then ring up the ration-free items. These are items which do not compete on the local markets, such items as clothing and athletic shoes. Ration-free items do not count toward the limits.

Finally, we take all of the forms generated in this process, which is about 400,000 forms per month, and pass them to U.S. Forces Korea. Then they are processed to identify apparent violators.

Now, even with these procedures, some merchandise does reach the black market. My personal estimate is that it is minimal in comparison to our total sales.

The military can become far more restrictive in administering the ration controls. However, if we restrict the flow of all goods to the black market, and the Government of Korea does nothing to reduce the insatiable demand for American products, then we become subject to an elementary law of economics. With low supply and high demand, then the price of the merchandise goes up and it becomes more of a temptation for our people, including our own employees, to participate in the black market.

The implementation of harsher controls and greater punishment, I believe, could and would adversely affect morale, retention, and the quality of life.

We will continue to work with U.S. Forces Korea to reduce the flow of goods to the black market, but the system, the ration control system, that we have today is not perfect. It does represent a reasonably effective system in restricting the flow of merchandise without forcing our customers to live in an unreasonably controlled environment.

I ask that you not impose additional or artificial controls on that system.

Sir, I will be happy to answer any questions you have.

Senator LEVIN. Thank you so much, Colonel Donahoe.

Senator Pryor, we welcome you, and if you have any opening statement, we would be glad to hear it now.

OPENING STATEMENT OF SENATOR PRYOR

Senator PRYOR. Senator Levin, I really appreciate what you are doing here. I think this is a case similar to one of the first impressions that I can remember in the Senate, when a member of this Committee and a Member of the United States Senate opened up other issues that very few of us knew anything about. This is not a warning to the witnesses, but it is an observation about Senator Levin, who came to the Senate at the same time I did.

When I was raised down in south Arkansas as a youngster, I was always told that if a turtle bit you, he wouldn't let go until it thundered. I have seen Senator Levin come forward on some issues during the last 10 years for example, proposing a taxpayers' bill of rights, and he has never let up. A few years back, looking at something called Wedtech, he never relented, he never stopped; he stayed with the issue. Senator Levin has pursued other areas—the Independent Counsel Legislation, the Inspectors General Legislation fraud and waste in the Department of Defense and other areas of government—he is truly one of those people who, when an issue is there and he senses that it is wrong, he is not going to stop until it is corrected. I have known him for a decade, I have admired him for a decade, and I admire him for what he is doing today by once again pioneering an area that frankly I didn't know existed—it is not only illuminating, but it is saddening.

I look forward to working with Senator Levin on this issue and others that he is involved with. I think that the issues here are pretty dramatic, and I think pretty awesome.

Thank you, Senator Levin.

[Senator Pryor's prepared statement follows:]

PREPARED STATEMENT OF SENATOR PRYOR

As usual, Senator Levin has put together an excellent investigative hearing. This hearing comes on the heels of his other investigative successes, including his work on EPA's derelict enforcement of Great Lakes pollution standards, the Wedtech scandal, Pentagon insider trading, and neglect and danger in our chemical weapons stockpile.

Today Chairman Levin has turned his sights on the black market for U.S. goods sold in our subsidized military stores in South Korea. 45,000 U.S. troops, 25,000 dependents, and a large number of authorized Korean nationals are permitted to buy these cut rate products. According to the GAO and military investigators, many of these tax-supported items are being turned over on the streets of South Korea at a huge illegal profit.

Mr. Chairman, the black market you have uncovered has a surprising collateral issue. The GAO has found that American rice is one of the most highly prized black market products in the South Korean black market. They say our troops in Korea are buying the equivalent of 170 pounds of rice per person, per year, whereas average rice usage is under 13 pounds per person.

Investigators suggest that most of this rice is sold on the black market with an almost 300 percent markup.

Mr. Chairman, why on earth is there such demand for black market American rice in South Korea?

The answer is that South Korea has a "Zero Import Quota" against all U.S. rice imports. That means not one grain of American rice can be legally sold in Korea. That also means American farmers are being unfairly cut out of export sales worth $350 million.

Mr. Chairman, in the early 1980's, South Korea cut us out of their rice market and set up a state rice trading company. Rice prices there are now supported at roughly five times the world market price.

This hearing is primarily about the black market for subsidized U.S. goods. Certainly the Pentagon has some explaining to do about this massive fraud. However, we need to take a stronger stand the South Korean's, whose restrictive trade policies toward U.S. rice and other commodities are harming many U.S. industries and which are the direct cause of much of the black market.

It is a tragic irony that while we protect South Korea with massive amounts of U.S. resources, including 45,000 troops, that country is refusing America access to many of their most basic markets.

I look forward to discussing with the GAO witnesses how the black market works and what we can do about it and I plan to ask the Administration's witnesses what they are doing to open Korea markets to U.S. products.

Again, Mr. Chairman, I commend you and this subcommittee for bringing another important issue to the public's attention.

Senator LEVIN. Thank you, Senator Pryor. I am glad I called on you.

Colonel Donahoe, is it fair to say that AAFES makes a profit on the items that are sold in our exchanges regardless of where those items end up?

Colonel DONAHOE. Yes, sir, that's true. That amounts to about 4 percent.

Senator LEVIN. So that even if they end up in the black market, we profit from that sale.

Colonel DONAHOE. The service member does, yes, sir.

Senator LEVIN. So that that puts us in a conflicted situation in a sense. We've got a profit from a sale that we are trying to stop.

Colonel DONAHOE. That's true. But again, my performance is not measured in terms of profits at all. It is measured in customer service.

Senator LEVIN. Isn't it fair to say that we've got a problem that is created by unfair trade practices? We have a country that has said "no" to our goods and puts restrictions on our goods, but they want to keep all of our people there; and then we've got that economic pressure to use these commissaries and exchanges as funnels, in effect, for American goods that can't get in legally.

Colonel DONAHOE. That's true.

Senator LEVIN. All right. And the sale of those goods costs us—that transportation subsidy—costs us in law enforcement; on the other hand it profits us in our morale, recreation and welfare fund. So it puts us in something of a conflicted situation.

Colonel DONAHOE. A dichotomy.

Senator LEVIN. Would you agree that when you look at the amazing sales volumes of scotch and Spam and rice and other items that many of these goods are just going into the black market?

Colonel DONAHOE. Sir, I would agree with a portion of that, but you have to look at it in a cultural context. For example, the GAO chart showed 33 cans of hair spray for every female in Korea. They did not count the female soldiers in that computation at all. But that works out to be about 2.5 cans of hair spray per month.

Senator LEVIN. Well, just compare the Chivas Regal scotch sales in Korea to European sales. In our commissaries, there was 50 times as much scotch, roughly, sold in our Korean commissaries, because they've got a black market in Korea, than is sold in our

European commissaries, because there is no black market in Europe. So that is clearly evidence that a huge amount of that particular item is just being funnelled right through our commissaries; isn't that true?

Colonel DONAHOE. Sir, I don't deny that some of that winds up on the black market. But you know, if you take that reverse figure, and you look at the wine consumption in Germany compared to the wine consumption in Korea, which would be many times higher, it doesn't mean that we are black marketing wines in Germany.

Senator LEVIN. No, it doesn't mean in that case for obvious reasons; but doesn't it mean in the Korean case that——

Colonel DONAHOE. Sir, it probably is. But in Korea, as in any country in the Far East, gift-giving, whatever, is a refined art, and if you ever want to give a gift in Korea that means something, Chivas Regal is the finest status symbol that you can give. I only point that out to say that you can't say all of that goes into the black market.

Senator LEVIN. Do you have any idea what percentage goes into the black market, say, of Chivas Regal?

Colonel DONAHOE. Sir, that is anybody's guess. There is no way to measure that. You can pick any percentage that you like.

Senator LEVIN. This is $60 a bottle scotch, right?

Colonel DONAHOE. Yes, sir, of which we sell about 5,700 bottles a month in a universe of 70,000 people.

Senator LEVIN. Yes, but to compare it again with Europe, which is the only comparison I know, it is about 50 times as much.

Colonel DONAHOE. Yes, sir, but that compared only Chivas Regal scotch.

Senator LEVIN. I know. You don't have any other figures showing less of different brands, do you?

Colonel DONAHOE. I can provide those for the record if you like.

Senator LEVIN. Do you really think that we're going to find that we sell less of different brand scotches in Korea than we do in Europe?

Colonel DONAHOE. Well, no, sir. The only scotch that we sell in Korea is Chivas Regal.

Senator LEVIN. I'm not sure what the other——

Colonel DONAHOE. Black Label is another scotch that was popular many years ago, and the sales of that are nil right now.

Senator LEVIN. You saw the figures on the Corningware, for instance. There are 10,000 families, and we're selling 35,000 sets of Corningware every year.

Colonel DONAHOE. That's true, sir, there are 35,000 sets. But that makes the assumption for toasters or any of those other products that, for example, like an iron, that a GI would never buy an iron. I would venture a guess that most of our GIs do have an iron to take care of their own clothing.

Senator LEVIN. Every year they buy one—every GI, every man, woman and child, every year?

Colonel DONAHOE. Sir, if you take those statistics that you were given, it works out to be about one every 2 years per customer population base that we have.

Senator LEVIN. Every man, woman and child?

Colonel DONAHOE. Sir, obviously, you are correct; some of that does go to the black market. But I don't want to leave you with the impression that every iron that we sell, every piece of Corningware, goes direct to the black market.

Senator LEVIN. No, no one suggested every—but a substantial percentage does?

Colonel DONAHOE. Quite a bit may go to that.

Senator LEVIN. An AAFES security official who had served recently in South Korea told our Subcommittee that the AAFES Command actively resisted and discouraged black market enforcement efforts. The investigator stated that AAFES officials felt that black marketing enforcement had a negative effect on sales. He said that there was constant pressure from his superiors not to press black market investigations for fear that they would cut into the profits.

Is that true? Is that possible?

Colonel DONAHOE. Sir, of course, I know that commander very well, and his statement was, I believe, as I received it from this individual, that it was low on his priority list. And I have to say that in the priorities that we have, the customer service is at the top. If you give me the option of going after black marketing or diversion or theft, I'll pick theft, because those goods also wind up on the black market but take the dollars directly away from the soldier and airman that we are trying to support.

Senator LEVIN. What is the incentive to discourage the black market? I mean, here we have a situation that we profit in a sense, at least our morale and recreation fund profits from it. Isn't that a built-in incentive to encourage sales?

Colonel DONAHOE. Sir, if the only thing that we were looking at was profit, I would agree with you 100 percent. But I go back to the theme of customer service, and we are there to provide a service to the member. And yes, we do make a profit from that. My problem as the retailer is when that customer comes up, I can't tell whether they are the black marketeer or the legitimate customer. I have to treat both of them exactly the same way.

Senator LEVIN. How does black marketing hurt you? How does it hurt us?

Colonel DONAHOE. How does it hurt us in the exchange?

Senator LEVIN. Yes.

Colonel DONAHOE. It really doesn't except in the volume of goods that we have to transport.

Senator LEVIN. So it is just that transportation subsidy?

Colonel DONAHOE. And the handling that goes with that; the cost of doing business.

Senator PRYOR. Could I ask a question, Senator Levin, on this point? Would that be permissible?

Senator LEVIN. Yes.

Senator PRYOR. I understand that AAFES makes a profit on certain sales—we understand that—and that approximately 50 percent of that profit goes to the morale, welfare and recreation fund that Senator Levin alluded to.

Now, where does the other 50 percent of the profit go?

Colonel DONAHOE. Sir, that's where we take the money to improve our own facilities, to build a furniture mart or, most recent-

ly, a car care center in Yongsan, to expand the services that we have for the customers—to build the Burger Kings that we have put over there, to build the pizza parlor or the snack bars for the soldiers and airmen.

So we use that income, and then for the future, that provides a facility which in turn——

Senator PRYOR. How many dollars are we talking about each year going into these two respective funds?

Colonel DONAHOE. Sir, out of $150 million, you are talking about a total of 4 percent profit—2 percent of that, which would be about—how much—some quick math——

Senator LEVIN. Six million.

Colonel DONAHOE [continuing]. About $6 million.

Senator PRYOR. Is the morale, welfare and recreation fund audited?

Colonel DONAHOE. Sir, those funds go two different directions. One goes to the Department of the Army, and that is where they build MWR facilities, and thus far this year we have returned about $4.7 million directly to the installation commanders to support their own MWR programs.

Senator LEVIN. And the more that flows through these commissaries and exchanges, the bigger that number is.

Colonel DONAHOE. Not the commissaries, sir. The commissaries operate with appropriated funds and are separate from the exchanges, and they do not generate a profit.

Senator LEVIN. The more that it flows through the exchanges——

Colonel DONAHOE. The exchange, yes, sir.

Senator LEVIN [continuing]. The bigger that number is that the commander gets each year.

Colonel DONAHOE. That is a true statement, sir.

Senator LEVIN. I think that is clearly a built-in disincentive—and I understand that, by the way. My pique is aimed at this system where we are there, at great expense, defending South Korea as well as our own interests, where their darned unfair trade practices are creating a black market, and we are therefore spending a whole lot of transportation subsidy and personnel time, trying to protect them against the black market that they created. And we have this unusual situation where part of us benefit from that same black market, because the welfare fund will benefit from it. On the other hand, we have this transportation subsidy, and 20 percent of our criminal enforcement time, roughly, in Korea is spent trying to enforce our laws against black marketing.

So that is the kind of double whammy. But I think what Senator Pryor is getting to is there is this built-in disincentive to enforce these laws, because we benefit—or part of our operation benefits from the more sales, the better.

Colonel DONAHOE. And sir, that's the way the system works worldwide. It is just in Korea that we have the small number of people who divert the goods to the black market.

Senator LEVIN. Which is also open, by the way. We have these photographs——

Senator PRYOR. Who is in charge of enforcement of all this? I'll bet Senator Levin has asked that.

Colonel DONAHOE. Sir, on the military side, you have the Army Criminal Investigation Division; on the Air Force side, the Office of Special Investigations, and the Naval Investigative Service. We also have an extensive effort to look for it because in diversion, the same procedures that are used for diversion are also used for theft. So therefore we look for that and try to find it, and whenever we do, then we begin the separation process to get rid of the individuals who participate.

Senator PRYOR. Now, if your investigators find a South Korean out there actively soliciting a GI to purchase items from the black market or for the black market, who prosecutes? Is he arrested? Do we arrest the South Korean? Does the South Korean Government arrest the South Korean?

Colonel DONAHOE. Yes, sir. It is entirely up to the South Koreans. We do not have prosecution authority over the South Koreans. My only action if it is an employee is separation, and then I have to rely on the South Korean Government to take whatever action they want.

Senator PRYOR. Colonel Donahoe, how many have been prosecuted?

Colonel DONAHOE. Sir, I cannot answer on the South Korean side. They do not maintain the records. All I can tell you is over the past 3 years that we have apprehended and separated 88 of our own employees for participating in the black market.

Senator LEVIN. But it is fair is it not, Colonel, to say that South Korea does not enforce their laws; that there are open black markets in South Korea? Is that not fair?

Colonel DONAHOE. Sir, that is absolutely the truth.

Senator LEVIN. And that we are enforcing the law against our own people, while they ignore their laws?

Colonel DONAHOE. Only to the extent that the GAO mentioned where there is something very large——

Senator LEVIN. Except in unusual circumstances, they ignore their laws——

Colonel DONAHOE. You are 100 percent——

Senator LEVIN [continuing]. There are open black markets—according to this report that we've gotten from our embassy there, "the finest neighborhoods in Seoul have their black market stores, the fanciest department stores cheerfully sell black market items in Seoul." So we have a situation where you've got this open black market going on in Seoul, and they do very little about it.

Colonel DONAHOE. That's true.

Senator PRYOR. Once again I want to compliment you, Mr. Chairman.

Senator LEVIN. Thank you.

Would you agree, Colonel, with the investigators for the Air Force Office of Special Investigations at Osan, who told us that black marketing is "rampant"?

Colonel DONAHOE. Sir, I would say that it is there, it is in volume, but I'm not sure I would use the word "rampant".

Senator LEVIN. You would not use the word "rampant"?

Colonel DONAHOE. Because I can't define it. I cannot tell you how many people participate in the black market, and I can't tell you what percentage of goods go there.

Senator LEVIN. Would you say it is significant?

Colonel DONAHOE. Yes, sir.

Senator LEVIN. Let me just ask that same question of Colonel Hughes. Would you, Colonel, say that black marketing is "rampant"? Would you agree with those investigators for the Air Force Office of Special Investigations at Osan?

Colonel HUGHES. Sir, I would prefer to agree that it is indeed significant, and it is a problem for us. I also have a problem with the definition of "rampant." But it is a significant problem, and we acknowledge that readily.

Senator LEVIN. Would you be willing to say it is a major problem?

Colonel HUGHES. Yes, sir.

Senator LEVIN. Colonel Hughes, what role does South Korea play, in reality, in enforcing the SOFA Agreement with us? We are supposed to enforce the law, in effect protect them from the black market that they have created. We are supposed to do that, quote, "in cooperation with the Korean Government."

How would you describe their efforts—minimal?

Colonel HUGHES. Sir, specifically, we have several venues in which we can express our concerns about black marketing. We have, of course, the Joint ROK-U.S. SOFA Committee. We also have an Ad Hoc Subcommittee on Illegal Transfer of Duty-Free Goods. Both of these are venues through which we can express our concerns and encourage the Korean Government to participate more actively in areas that we have selected.

I also think that it is important——

Senator LEVIN. All that can be done, but as a practical matter, while we have prosecuted hundreds of military personnel for major and minor violations in order to keep our side of the Status of Forces Agreement, is it not fair to say that the Koreans aren't helping out much?

Colonel HUGHES. Sir, the Koreans report to us that in the years 1985 through 1988, that they did indeed prosecute 6,000 Korean nationals.

Senator LEVIN. You've seen pictures here this morning of just open black market in Seoul. People just go in and order stuff on the black market if it is not on the shelf. There are black market stores in Seoul, and that is what they carry.

Now, if you have that open black market, if Korea wanted to end it, couldn't they do it tomorrow?

Colonel HUGHES. Sir, they could certainly have a dramatic effect tomorrow. They control the demand side. We control the supply side. They could remove those items from the open black market. We have asked that they——

Senator LEVIN. They could end that open black market tomorrow——

Colonel HUGHES. They could, sir, yes.

Senator LEVIN [continuing]. If they wanted to.

Colonel HUGHES. Yes.

Senator LEVIN. They don't want to.

Are you troubled by all this, that it is sort of a double standard, that we are prosecuting our people here while they are ignoring the other end of it? Does that bother you?

Colonel HUGHES. Sir, I am deeply troubled by the entire process.

Senator LEVIN. Colonel Donahoe?

Colonel DONAHOE. Yes, sir, I am. But I have seen some progress. You know, the GAO charts had the sale of Spam up there as one of the more popular items. Spam is the meat of choice in Korea. And just recently, Spam is now being packed in Korea—you can see the labelling on there—and since that has happened, under license from the Hormel Corporation, an American manufacturer, we have seen the sale of Spam just decline perceptibly.

Senator LEVIN. In other words, there is a restriction on American-made Spam. That's the bottom line. They have restricted our Spam, required that it be produced in Korea, and now that it is produced in Korea, obviously the black market has disappeared.

Colonel DONAHOE. There is no more demand for that product on the black market.

Senator LEVIN. Well, there is a big demand for that product, but now it is being filled by Korean-produced Spam.

Colonel DONAHOE. That's correct.

Senator LEVIN. That's the way the demand has been filled.

Now, we don't treat Korea that way when it comes to their goods coming in here, but that's the way they treat our goods. We'll leave that up to the Commerce Department and the Trade Department, but that doesn't make me less troubled. That adds to my troubles.

Colonel DONAHOE. I just want to point out that, as Colonel Hughes says, they control the demand side, and the supply is on our side.

Senator LEVIN. Colonel Hughes, how big a chunk of time do the Army Criminal Investigations Command and the Air Force Office of Special Investigations spend on the black market?

Colonel HUGHES. Sir, I don't have a specific percentage on that.

Senator LEVIN. Could you estimate it? We have heard 20 percent.

Colonel HUGHES. I think that 20 percent is probably the best estimate that we can give at this time, sir.

Senator LEVIN. Let's look at one other item, here. We've got a limit, as I understand it, of three cases of beer a month—does that sound right?

Colonel DONAHOE. I think it's four, sir.

Colonel HUGHES. Four units of alcohol, sir, which may be four cases of beer or four bottles of whiskey or any combination thereof.

Senator LEVIN. All right. Now, I know you guys don't drink beer any more than I do——

Colonel DONAHOE. I drink only American beer.

Senator LEVIN [continuing]. And I should know this answer, and I am embarrassed to ask—how many bottles of beer in a case?

Colonel HUGHES. Twenty-four, sir.

Senator LEVIN. Twenty-four. So we've got about 96 bottles of beer—it sounds like a song—but we've got about 96 bottles of beer per month, per person using that store.

Colonel DONAHOE. That's the upper limit, yes, sir.

Senator LEVIN. Yes, that's the limit. So we permit three bottles of beer a day for every purchaser?

Colonel DONAHOE. If you used it all in beer, yes, sir.

Senator LEVIN. Colonel, you seemed to give a very straight answer on your being troubled. What troubles you the most about this system?

Colonel HUGHES. Sir, two things trouble me as well as the entire command. Number one, we know that black marketing is not right and that it is very frustrating and an irritant to the overwhelming number of honest customers who use our facilities. They express their concerns and their frustrations with us frequently. We need their input in order to develop modifications to our system.

It is the impact on the morale and the quality of life that the black marketing has on our families and the soldiers, sailors, airmen and marines who are serving so proudly in Korea that bothers me. And of course, it also bothers me that we are not indeed achieving our objective for preventing the duty-free goods from being distributed to unauthorized users.

Those are the two primary reasons that it bothers us in U.S.F.K., sir.

Senator LEVIN. The GAO interviewed a number of unit commanders in Korea, and many of them made comments that the Koreans don't care about black marketing, and if Korea would open its market, there wouldn't be a problem.

Do you agree with that, that if Korea they would open its market there wouldn't be a problem?

Colonel HUGHES. Sir, I am not qualified to answer that.

Senator LEVIN. All right.

Colonel DONAHOE. Sir, can I respond to that?

Senator LEVIN. Sure.

Colonel DONAHOE. I know that's a fact. Cigarettes used to be a big black market item. In May of 1988, the Koreans opened the market to American cigarettes. We have seen the sales since that time of American cigarettes decline just perceptibly. As a matter of fact, the off-base price is the equivalent of the price that we charge in the PX.

In May of this year, the Korean Government allowed the importation and sale of Taster's Choice and Maxwell House instant coffee, and since that time, we've seen sales drop on that, also.

And I gave you the example of where the American manufacturer had authorized the licensing and packing of Spam in Korea and the sale on the open market; our price is $1.95; the Korean price for this can is $3.33, and since that time we have seen the sales drop perceptibly off, also.

So that tells you there is an insatiable demand. When that demand is filled, then there is no more black market problem.

Senator LEVIN. I'm just curious about one thing to go back to those oxtails again. They were stocking about 70,000 pounds per month. Why do we keep doing that? We know most of that ends up on the black market.

Colonel DONAHOE. Sir, we also know that about—pick a number that you like—but about 76 percent of the spouses that we have in Korea are of Korean nationality, and oxtail soup is a staple of the diet as well as oxtails. So the demand is there even in-house.

Senator LEVIN. The legal demand is there?

Colonel DONAHOE. A legal demand.

Senator LEVIN. So we just can't filter it out?

Colonel DONAHOE. That's right.

Senator LEVIN. Okay. We may have additional questions for you for the record. You are excused. Thanks for coming.

I am going to have to recess this for about 10 minutes to go and vote. There is a vote on, and I am sorry to have to delay our next panel, but we've got no choice.

Thanks very much.

[Recess.]

Senator LEVIN. We'll come back to order. And it looks like there may be another vote coming up shortly, which you two, I think, are used to, but nonetheless if you want to summarize so we can try to complete this before I have to go and vote, that would be appreciated.

Sandra Kristoff is here, representing the U.S. Trade Representative. She is the Assistant Trade Representative for Asia and the Pacific.

The Department of Commerce is represented by Scott Goddin, Director of the Korea-Taiwan Division of the International Trade Administration.

We are grateful to both of you for being here.

Again, if you can summarize, it may save double the time this time.

TESTIMONY OF SANDRA KRISTOFF, ASSISTANT U.S. TRADE REPRESENTATIVE FOR ASIA AND THE PACIFIC, REPRESENTING U.S. TRADE REPRESENTATIVE [1]

Ms. KRISTOFF. Thank you very much, Mr. Chairman.

We too are very pleased to be with you today to talk about the black marketing issue in Korea and, from my perspective, to talk about that in terms of its relationship to overall trade liberalization in that country.

Certainly the black market in Korea has been in existence for some time. It is a fact that no one will dispute. I believe that we agree with the assessment of the American Chamber of Commerce in Korea and other Government officials that have appeared before you, that the black market is truly a result of Korea's restrictive import policies, its restrictive import practices.

The items that the Government Accounting Office has identified as products being particularly popular on the black market are precisely those products that the Korean Government places under restriction in terms of quotas, tariffs, taxes, and run predominantly in the consumer area.

Over the last several years, I believe that U.S. trade initiatives have been somewhat successful in reducing some black market traffic in some of these consumer items. I guess an example that was used earlier and one that I think we are justifiably proud of is the cigarette case where, as a result of Section 301 negotiation with the Koreans, we were able to open the cigarette market, and the presence of cigarettes through the black market or less than legitimate channels has been substantially reduced.

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[1] See p. 96 for Ms. Kristoff's prepared statement.

The agenda with the Koreans over the last 5 or 6 years has focused primarily on pure market access concerns. Since the fall of 1985 the Koreans have, albeit with a good deal of bilateral pressure from us, including 6 Section 301 cases, have opened the market in a number of areas—insurance, advertising, intellectual property, cigarettes, as I mentioned, wine and some agricultural liberalizations.

Last year as part of the 1988 Trade Act, we undertook a number of additional initiatives to further open the market. In the May time frame we concluded the so-called Super 301 package with Korea where we had agreements on investment localization and liberalization of certain agricultural products of interest to U.S. exporters, reduction of several nontariff barriers in the ag area, including blending requirements on orange juice and some elimination, or at least lessening, or phyto-sanitary barriers to certain fruits that had been hindering some U.S. export interests.

We believe that the achievements that we have had with Korea over the last 4 or 5 years are important, have pointed Korea in the right direction of opening its market, actually in its own economic interest, and we will continue, however, over the course the next 12 months in particular to press the Korean Government to continue along that trend. Two or three issues of particular importance that come up to us over the next 6 or 8 months are the beef dispute that we currently have ongoing with them where we are trying to open the beef market for U.S. exporters; intellectual property enforcement where, on November 1, we have to make an evaluation of the extent to which Korea has provided adequate and effective intellectual property enforcement, and telecommunications market access where we hope by February of 1990, pursuant to the 1988 Trade Act, to have an agreement on a framework for opening that market to U.S. telecommunications services.

We are also working very hard in the GATT and in the Uruguay Round to bring Korea up to the standards of international trade obligations of the developed country. This week in Geneva, we are working with the other contracting parties to encourage Korea to disinvoke its balance of payments justification for import restrictions, and we are continuing to work closely with them in the Uruguay Round to urge them to exercise a leadership role, particularly on the new issues of services investment and intellectual property, to extend and create new GATT disciplines in these areas.

I think that my agency along with the rest of the interagency process, our colleagues that work with us on these trade issues, are committed to maintaining an active and aggressive dialogue with Korea over the next year or 2 to try to get them to continue to open their market rapidly.

I think I'll stop there for now and ask Scott if he has anything he wants to add.

Senator LEVIN. Thank you, Ms. Kristoff.

Mr. Goddin.

TESTIMONY OF SCOTT GODDIN, DIRECTOR, KOREA-TAIWAN DIVISION, INTERNATIONAL TRADE ADMINISTRATION, REPRESENTING U.S. DEPARTMENT OF COMMERCE [1]

Mr. GODDIN. Mr. Chairman, I'll keep my remarks brief.

I am pleased to appear today. I will comment very briefly on the changes in Korea's overall import regime and some of the changes we expect, and describe very briefly Korea's system of taxation and how that affects U.S. imports.

Since 1983, as Ms. Kristoff indicated, the Korean Government has eliminated a significant number of barriers to imports and to direct investment. Additionally, there are 3 tiers of barriers to get into the market. These include import licensing on which, over the last 6 years, Korea has lifted traditional import licensing restrictions. The second barrier is high tariffs. They have since 1983 undertaken two 5-year plans to reduce tariffs and have in place an additional program through 1993, when tariffs would be lowered to an average level of approximately 7 percent. In my written testimony, you can see how some of the tariff levels have come down on products that have been of interest to U.S. exporters.

Finally, the last area is special consumption taxes which are levied on all luxury and some consumer goods—both imported and domestic—have traditionally served as a barrier to imports. These are applied, again, both to domestic and imported goods, but tend to raise the price of imports proportionally more because the base price includes the tariff. These taxes, however, have also been reduced, were reduced in 1988 to stimulate domestic demand.

Despite the progress Korea has made, there are still restrictions on a number of products. Most industrial products including luxury goods, automobiles, washing machines, are freely importable. Quantitative restrictions remain in place on over 200 agricultural products including fruits, fish products, vegetables and processed foods. Tariff rates range from 8 to 15 percent for most industrial products and raw materials, while agricultural products still carry very high tariffs of between 30 to 50 percent.

As the more traditional barriers have come down, the attention of U.S. exporters and our efforts in the government have focused on the more subtle trade barriers. The taxation system and its impact on our imports; restrictive import financing procedures; cumbersome and restrictive standards and non-transparent customs clearance procedures have all been subjects of industry complaints and our efforts particularly in the Super 301 discussions.

As Ms. Kristoff indicated, we reached agreements last May, prior to Super 301 designation, with Korea. One agreement on localization, which address Korea's import substitution policies, removed a number of nontransparent trade barriers both to food products and cosmetics.

We expect import liberalization in Korea to continue. The tariff reduction plan, as I have described, is already in place and likely to continue through 1993. In 1989, the Korean Government actually accelerated some of the planned reductions on a number of products.

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[1] See p. 100 for Mr. Goddin's prepared statement.

As part of the agreements reached this year, we also have a liberalization schedule. Liberalization schedule means removal of import licensing restrictions on approximately 70 products of interest to U.S. agriculture and fishery exporters. This liberalization schedule will be implemented over the next 3 years.

In addition, we have agreements on wine, and one part of the agricultural agreement will assure market access for whiskey within the next year.

In terms of the relationship to the black market, we confirm that the GAO's list of items which are doing brisk business on the black market are those on which barriers exist. We are confident, however, that the steps that Korea has taken to remove restrictions, and our continued efforts to encourage further removal and accelerated removal of those restrictions will help to redress the situation. Our market access objectives will continue to be directed toward opening and assuring legitimate marketing and distribution opportunities for U.S. products.

Thank you. I'll be happy to answer any questions.

Senator LEVIN. Thank you very much, Mr. Goddin.

We have heard testimony this morning, Ms. Kristoff, that the black market in South Korea is "rampant," that it is "significant." Do you agree with that?

Ms. KRISTOFF. Well, I certainly agree that the black market is visible, readily visible, when you visit Korea and that there is a clear demand in Korea for the products that are available in these easily-accessible retail outlets and that the demand is being filled by the leakage of these products into that system.

Senator LEVIN. So you agree there is an open black market in South Korea?

Ms. KRISTOFF. I think when you go to Korea you can see an open black market and that it reflects the demand of the Korean consumer for these products.

Senator LEVIN. The Executive Vice President of the American Chamber in Korea wrote us that the environment in which the black market thrives is created by the Korean Government's restriction of access of consumer goods to the Korean market through legitimate business channels, and I think you said you agree with that.

Ms. KRISTOFF. Yes. I was in Seoul a week ago, and I spoke with Pete Booth at that time. I do agree with the content of the letter that he addressed to you in July of this year concerning the black market, and I think it is readily apparent that where there is a demand, and the supply is provided by this leakage into the black market system that you look for the underlying cause, and the cause is the Korean Government's restrictive import policies.

Senator LEVIN. Mr. Goddin, we have a situation here where Korea has put restrictions on our goods. We can't freely export these goods there. There is a demand for those goods, and there is an outlet now for those goods. It is through our exchange system. That is the outlet. Why should we enforce laws to stop that outlet, to prevent that market for our goods from taking place? It is sort of strange, it seems to me, that we are spending a whole lot of money enforcing our laws to try to protect South Korea from a black market that their restrictive practices has created.

What is your reaction to that?

Mr. GODDIN. I think, Senator, that this morning there were a number of methods described to deal with that situation, and I believe that improvement of those methods——

Senator LEVIN. First of all, do you agree with that analysis?

Mr. GODDIN. I do, I do.

Senator LEVIN. Okay.

Mr. GODDIN. And I agree that further improvement of control of that method of distribution need be addressed.

I think from our perspective, what we are hoping to do in terms of securing market access for our products is supportive of that effort. I agree with you that there is some disincentive to our enforcement of those laws when they do have a conflictive effect—which is the term you used this morning—on the military presence. But I think to the extent that we devote our efforts to assuring market access through legitimate distribution channels that that can be supportive of our efforts.

Senator LEVIN. Now, you are representing the Department of Commerce. The more we enforce our laws, it could be argued, the less rice we are going to sell; the more we enforce our laws, the less—you fill in the blank—some other American products we are going to sell. When Korea ignores their own laws for the most part, you've got an open black market, and when their restrictive trade practices have created that black market, why should we spend money enforcing our laws which will have the result of our selling less goods in Korea?

Mr. GODDIN. I guess in my opinion, some of the laws—which laws are you going to enforce? There are laws that we have applied to Korea to secure market access, and that has been the case in beef, that has been the case in cigarettes, that has been the case in wine.

Senator LEVIN. My question, though, refers to why should we enforce rules against how much rice can be bought in an exchange. Why should we care how much rice is bought in an exchange? The fact that a lot of it ends up in the Korean market is a big plus for American rice producers. So why are we restricting how much rice American service personnel can buy in an exchange?

Mr. GODDIN. I am not competent—I would not claim competence, sir, to be able to admit what our obligations might be under the SOFA and what our responsibilities would be.

Senator LEVIN. But for that obligation—I mean, putting aside that obligation under the SOFA. Does that make sense to you that we would restrict the amount of rice that we can ship to Korea—that we are restricting it? Why should we restrict it? Korea is the one that puts the restriction on it. Why should we restrict it? Why should we do anything to restrict it? They've created the darned black market with their restrictive trade practices. Why should we participate in it? That's my question.

Mr. GODDIN. I don't have an easy answer for that, sir. I think again from our area of competence that our efforts to address the situation that sustains that black market is where our efforts can be directed.

Senator LEVIN. Okay. Ms. Kristoff, can you answer my question—why should we participate?

Ms. KRISTOFF. I am not sure that I could answer it any more accurately than Mr. Goddin. I mean, our area of competence extends to the trade policy concerns, that is, trying to increase the supply of legitimate goods in the Korean market. Presumably, the policy rationale underlying the ration control system has some competing and justifiable policy concerns that you would want to control those——

Senator LEVIN. But from the Trade Representatives point of view——

Ms. KRISTOFF. From the Trade Representative's point of view, the answer to the black market problem in Korea is to have the Korean Government open the market for those products where there is clearly a demonstrable demand already and to move them into the legitimate importation/distribution system. I believe that in a number of marketing opening steps that we have taken in cigarettes, wine, some of the tariff reductions, some of the fruits and vegetables, frozen potatoes that we got opened a couple years ago, that once those products move into the legitimate import/distribution system, the black market in those products disappears, and the demand in commissaries for those products substantially declines.

Senator LEVIN. Is the rate of opening Korean markets frustratingly slow?

Ms. KRISTOFF. As an individual negotiator, yes, frustratingly slow. I think looking at it over the last 5 years, I would say that we have made enormous strides with Korea, both in terms of satisfying individual U.S. export interests, where we have targeted products and gone after removal of the quota, the license, or a reduction of the tariffs, and we have some success stories there. But I think more importantly over the last 5 or 6 years, the growing recognition on the part of the Korean Government that market opening is in its own national economic interest, that it is not something that ought to be pursued only and solely as a result of U.S. bilateral trade pressure, but that an open Korean market is in the interest of Korean economic development.

Senator LEVIN. Is that trade pressure also useful to opening markets?

Ms. KRISTOFF. Yes, absolutely.

Senator LEVIN. You have heard the GAO identify for us a number of items which are obviously in great demand in Korea but available primarily through the black market.

Ms. KRISTOFF. Right.

Senator LEVIN. Do we include these and other black market items on our list for liberalization action?

Ms. KRISTOFF. Yes, I believe we do. I guess I'd turn to Scott for a more detailed answer. I can tell you that for every product that an American exporter, agricultural or industrial, has come into either Scott's office or mine and has asked us to take up the argument on their behalf for the removal of a Korean Government border restriction, we have gone after that product—certainly cosmetics.

Senator LEVIN. Specifically, the black market list of popular items; have you gone after those?

Ms. KRISTOFF. I think I have—without having the list in front of me, if it includes things like consumer products, cosmetics, consumables, the answer would be yes.

Senator LEVIN. We'll get you the list, and then I'd like to get back to us as to what actions you have taken and what achievements you've had, okay?

Ms. KRISTOFF. Certainly.

Senator LEVIN. One of the achievements is that for refrigerators the tax has gone down from 32 percent to 28 percent.

Ms. KRISTOFF. Right.

Senator LEVIN. That seems like mighty frustratingly slow progress: Would you agree?

Ms. KRISTOFF. I would say that a high tariff in the 20 percent range compounded by taxes on top of tariffs is going to put an imported product at a competitive price disadvantage to a domestic product.

The answer to the refrigerator question, or the refrigerator export problem, really goes beyond just that individual product. You have to take a look at the overall Korean tariff structure and the tax structure and try to get the Korean Government to make systemic changes to the tariff structure and to the way in which taxes are applied.

It is better to do it systemically across the board and bring them down to an average tariff level comparable to the OECD countries than to be nickeled and dimed on a product-by-product basis.

Senator LEVIN. Did you see the GAO figures that show that 24 percent of our refrigerators were sold with bogus plates?

Ms. KRISTOFF. I did not see that; I heard that anecdote when I was in Seoul last week. Refrigerators was the single most popular example when we discussed this issue last week.

Senator LEVIN. Does that figure surprise you?

Ms. KRISTOFF. Not really.

Senator LEVIN. How about washers? Did you see the figure on washers? Over 26 percent of the washers sold in our facilities are bought with bogus identification plates.

Ms. KRISTOFF. Right.

Senator LEVIN. Does that surprise you?

Ms. KRISTOFF. It doesn't surprise me.

Senator LEVIN. You said you agreed with Mr. Booth's analysis. Do you agree with him that the black market serves as a pressure valve that moderates internal political pressure for broader market opening?

Ms. KRISTOFF. When I was re-reading his letter to you last night—I am not 100 percent in agreement with Mr. Booth on that. I think it is quite true that the Korean consumer who takes advantage of the availability of these products through the black market is the Korean consumer who can afford this. Those people generally have a tendency to be the more influential decisionmakers, if you will. So one could make the argument that the existence of the black market allows the Korean Government to not take the steps needed to open its market for legitimate imports because those consumers that they care about have access to these products anyway.

Counterbalanced against that is the existence of two 5-year liberalization plans on tariffs; well over 300, 400, 500 products being

lifted or removed from import licensing; some reasonable successes in the agricultural area—all of which was done by the Korean Government on its own initiative.

Senator LEVIN. Without pressure?

Ms. KRISTOFF. Without pressure. Those were unilateral liberalization measures. The Koreans, I think, announced three or five unilateral liberalization packages in the 1986–1987 period on their own, spontaneously.

Senator LEVIN. Do you think trade liberalization comes without pressure in Korea?

Ms. KRISTOFF. I think increasingly the Korean Government has come to the recognition that market opening is in its own domestic economic interest. I think some of the trade figures that you look at this year, some of the domestic economic figures in Korea, you see that the growth of the Korean economy, projected at about 7 percent this year, is being stimulated by domestic demand rather than being export-driven. So I think the Korean economy from a macro level is shifting from an export-dependent economy into on where you've got more growth in domestic demand. To satisfy that, they are going to have to open the market. I believe that the economic policymakers advising the President have embraced that free trade philosophy. I think the slowness of the market openings in Korea is a result of domestic political constraints as the Korean political process has moved into its so-called "democratization" phase, and it makes it difficult particularly in the agricultural area where there is political support for the ruling party for the Korean Government to move on other than a gradual, step-by-step basis.

Senator LEVIN. Do you see that political pressure, which has dominated to date, lessening?

Ms. KRISTOFF. I would say that the Korean Government is, from our point of view, in the trade area facing, most particularly in the agricultural area, domestic political pressures; that by and large in the industrial area and increasingly in the services area, the policymakers that we deal with have done more than embrace the free trade philosophy, the open markets expand trade philosophy, but are actually implementing policies to that effect.

Senator LEVIN. The question is, though, do you see the political pressure which is the counterweight to that theoretical advice that they are getting from their policy advisors, do you see the political pressure on the Government which has caused them to restrict their markets lessening? That's my question.

Ms. KRISTOFF. I see it continuing. I don't see it getting any worse. Certainly, the anti-American sentiment that I experienced 4 or 5 years ago in Seoul, I don't see at the same level today, despite the recent storming of the ambassador's residence.

Senator LEVIN. Do you see any reduction in that political pressure on the Government?

Ms. KRISTOFF. In areas other than agriculture, yes.

Senator LEVIN. In agriculture?

Ms. KRISTOFF. In agriculture, I believe that's probably the single greatest area of concern for the Korean Government domestically, politically, certainly in terms of economics, and probably in terms of U.S. trade policy priorities vis-a-vis Korea at this point in time.

Senator LEVIN. Is it fair to say, then, that you don't see the reduction of political pressure in that area on the Government?

Ms. KRISTOFF. It is fair to say that, sir.

Senator LEVIN. The agricultural attache, Ralph Gifford, I believe his name is, wrote in a memo to the Department of Agriculture from the American Embassy regarding our inquiry, the Senate subcommittee inquiry into the black market, the following: "The finest neighborhoods have their black market stores, the fanciest department stores cheerfully sell black market items. We are not allowed to bring up the black market at trade talks as an example of demand because it is technically our responsibility to police our commissaries."

Do you know anything about that, Ms. Kristoff?

Ms. KRISTOFF. I have no first-hand knowledge about that. I can tell you, though, that in the cigarette negotiations, in the wine, beer, and I believe in the whiskey negotiations, although I wasn't part of the latter, we certainly did address the issues of smuggling and leakage of these products into the black market, and there was no shyness or reticence on the part of the U.S. negotiators.

Senator LEVIN. Should there be any reticence about bringing up the black market at trade talks as an example of the demand for these goods?

Ms. KRISTOFF. I believe that I myself have used it as an example.

Senator LEVIN. I'm just saying should there be any reluctance, and if there should not be any, could you get the word to these folks that they are free to raise these examples as evidence of demand?

Ms. KRISTOFF. I would agree that when you have evidence of demand for a particular product through the existence of a black market and open retail outlets that that is a good argument for a U.S. negotiator to use with his or her Korean counterpart.

Senator LEVIN. And a legitimate argument?

Ms. KRISTOFF. I believe so.

Senator LEVIN. Could you, then—I don't know if you have a copy of that letter, but we'll get you the letter—could you, then, get—assuming the head of your office agrees with you—could you get some guidance to the embassy?

Ms. KRISTOFF. I will certainly bring it to the ambassador's attention.

Senator LEVIN. Okay. And we will get you that black market list, also, so you can tell us if they've been included in trade liberalization talks? Also, please let us know what changes have occurred in the Korean treatment of those items over the last few years.

Ms. KRISTOFF. Thank you.

Senator LEVIN. We have had a lot of trouble with restrictions on cosmetic products. Is that an area, also——

Ms. KRISTOFF. That is an area that is under very active discussion with the Korean Government, ranging from market access concerns to protection of intellectual property such as trademarks.

Senator LEVIN. When our staff suggested the extent of the black market as identified by the GAO to your office, you indicated that the volume and dollar amounts involved in the black market reflect the fallacy of the Korean import system. Ms. Kristoff, what is that fallacy?

Ms. KRISTOFF. I must have used that word before I had my coffee. I think it is the notion that you can force a dampening of demand by placing undue restrictions or taxes on individual products. Import restrictions do not create growth in a domestic economy. I think the Korean Government is coming around to realizing that on its own and that we are seeing the market open for some of these consumer goods that the Koreans now have disposable income to spend on.

Senator LEVIN. Mr. Goddin, your department provided cables to the Subcommittee relating to an incident this summer involving U.S. grapefruit. In June, there was a controversy over the testing of grapefruit for the substance alar. Even though U.S. industry officials say no alar is used on grapefruit, sales of U.S. grapefruit in South Korea fell 50 to 90 percent after erroneous information concerning the presence of alar on grapefruit was released by Korean Government and industry officials.

Those cables relate that the Korean Government and industry were working hand-in-hand to use this phony issue to embarrass the United States and reduce imports of U.S. agricultural items. Korean officials fanned the flames of anti-import sentiment against the United States, according to those cables that your department provided to us. Some of these same citrus fruit products are popular on the black market. Yet, as we see in this case, Korean Government and industry officials continue to resist their legitimate import for sale.

Is that the kind of treatment that we can continue to expect?

Mr. GODDIN. I think depending on the product, sir. Agricultural products, as we have seen in light of recent incidents, bring up a special sensitivity among Koreans for a variety of reasons.

If we take the example of cosmetics, that is one that we have been working on for over 4 years. We removed an import licensing restriction, we reduced the tariff. We then faced an intellectual property rights violation problem. We then had problems getting companies to receive trading licenses to be able to import the product.

So there are, as I think we referred to in Japan, there are many layers to the onion. But I think that the way domestic demand has changed significantly in Korea in the last few years, that the mercantilist sentiment or the protectionist sentiment behind a lot of these types of activities or these kinds of activities would be reduced.

Senator LEVIN. Do you think that has something to do with the pressure that we brought to bear on them?

Mr. GODDIN. I think pressure helped.

Senator LEVIN. Are you bothered by what those cables told us about a phony issue of alar being raised? Does that trouble you at all?

Mr. GODDIN. Yes, sir.

Senator LEVIN. What troubles you about it?

Mr. GODDIN. What troubles me is that it represents one of many case histories of this type of difficulty in terms of trying to get products legitimately into that market.

Senator LEVIN. And a phony issue being raised to stop them?

Ms. Kristoff, are you troubled by that?

Ms. KRISTOFF. What I would like to see us do in our trade discussions with Korea is get to the point where we are addressing systemically, across the board, these barriers, rather than going after a tariff reduction or a license product-by-product and then, as Scott says, finding ourselves faced with an unanticipated, yet another hurdle; to work with the Koreans to come up with an agreement on legitimate phyto-sanitary regulations that would be applied to agriculture; to work with the Koreans to come up with an understanding of the kind of Customs testing on agricultural products that would be permitted; to work with the Koreans to come up with an agreed-upon list of sectors where investment would be allowed as opposed to being restricted.

I think if we continue down the product-by-product, item-by-item negotiating approach with the Koreans that we will always find ourselves with yet one more hurdle, yet one more barrier, and that we need to have some systemic, across-the-board, agreed-upon principles.

That's why I believe that it is imperative that we continue to work with Korea in the Uruguay Round to bring them into international disciplines at the developed country level.

Senator LEVIN. I share that goal, but in the meantime, I am troubled. Are you?

Ms. KRISTOFF. In the meantime, I spend a lot of time with my Korean counterparts, trying to hammer out resolutions to things from Estee Lauder's trademarks to the alar on grapefruit to counterfeit——

Senator LEVIN. Why is it difficult for you to say that you are troubled by that kind of activity on the part of Koreans? There seems to be some reluctance on your part to agree to that. Is that because you are not troubled when they raise a phony issue to keep out our grapefruits?

Ms. KRISTOFF. No, it is not that I am reluctant. I think that the Korean Government adopts positions, economic positions, trade policy positions, negotiating strategies and positions, that it views to be in its own interest. I have to treat those arguments one by one, and I have to knock them down as persuasively as I possibly can, irrespective of whether I am troubled or not.

Senator LEVIN. I think that is true, but I asked you whether you are troubled, and I find some reluctance—I'm not sure why. It seems to me it is fairly simple——

Ms. KRISTOFF. For me, it is not a question of whether I am troubled or not.

Senator LEVIN. But that was my question.

Ms KRISTOFF. Yes. And my answer is irrespective of whether I am troubled, these are the arguments that are presented to us that we have to attack, and it doesn't do me as a negotiator one bit of difference to be troubled or not troubled by it.

Senator LEVIN. Would we be trying to eliminate these things unless they bothered us?

Ms. KRISTOFF. We would be trying to reduce or eliminate restrictions on market access for products of U.S. export interest across-the-board on those that——

Senator LEVIN. Even if we weren't bothered by it?

Ms. KRISTOFF. If we have a competitive opportunity, and we believe that a Korean Government import policy impedes that competitive opportunity, then U.S. trade policy is committed to trying to reduce or eliminate that restriction either multilaterally or bilaterally.

Senator LEVIN. Thank you. Again, sorry for the interruption from that vote we had.

Thank you so much for coming.

Ms. KRISTOFF. Thank you very much, Senator.

Senator LEVIN. We stand adjourned.

[Whereupon, at 12:13 p.m., the Subcommittee was adjourned.]

APPENDIX

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m. EST
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South Korea: Black Marketing of U.S. Provided Goods and Efforts To Prevent It

Statement of
Donna M. Heivilin
Director, Logistics Issues

Before the
Subcommittee on Oversight of
Government Management
Committee on Governmental Affairs
Senate

GAO/T-NSIAD-90-1

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our review of black market activities in South Korea. This morning we will describe the causes for and the magnitude of the black market problem, the system that the U.S. Forces Korea Command uses to control black marketing, and the cost to the U.S. taxpayer of black marketing U.S. provided goods.

Simply stated, black marketing is the act of transferring duty-free goods sold in the commissaries, base exchanges, and other retail outlets to unauthorized individuals for profit or personal gain.

We know that black marketing of the duty-free goods is taking place, and we believe that it is widespread throughout South Korea. However, we are unable to determine how much of the goods are making their way to the black market. We saw goods from the U.S. Forces Korea retail system in Korean markets and stores. Also, we analyzed sales rates for selected items which indicate that the authorized consumers (authorized military, civilians, and their dependents) could not be consuming all of the merchandise sold. In addition, we discussed investigative case files and analyses with U.S. enforcement groups. These discussions indicate that the problem is widespread.

The ration control system costs about $12.1 million per year and has weaknesses that make it more of an inconvenience to honest shoppers than a hindrance to black marketeers. Moreover, as a result of the black marketing, honest shoppers often cannot buy the merchandise they want when they want it. It costs the U.S. taxpayers at least 14 cents for every dollar of merchandise that is black marketed. Neither the U.S. government nor the Korean government have aggressively or effectively dealt with the black marketing problem.

Under the Status of Forces Agreement with South Korea, U.S. personnel and other specified individuals are entitled to purchase items from U.S. Forces Korea retail outlets, such as commissaries and base exchanges. These outlets are not subject to Korean taxes. In return for this purchasing privilege, authorized consumers are obligated not to sell or transfer these duty-free items to others not authorized to receive them.

The U.S. armed forces, in cooperation with the Korean government, are required under the Agreement to take steps necessary to prevent abuse of this privilege. However, both governments have criticized each other from time-to-time for not doing enough to solve the problem. On the U.S. side, the government has criticized the Koreans for not cracking down on black marketeers and for not easing trade barriers on U.S.-made products. The Koreans have said that the United States is not doing enough to control black

marketing of U.S. goods. They say black marketing is a U.S. problem.

In addition to law enforcement, many U.S. officials believe the key to deterring black market activities is for the South Korean government to lift trade restrictions and lower tariffs on U.S. and other foreign products. U.S. officials believe that eliminating trade barriers and lowering tariffs would result in a corresponding increase of U.S. and other foreign products into Korea. Consequently, the demand for items from the U.S. military bases would decrease.

The 1988 tariffs on some U.S. made items are high. The tariff on beer, wine, and whiskey, is 100-percent, and on large appliances such as refrigerators, and washing machines, and music systems it is 30 percent. According to the Korean Ministry of Finance, tariffs are scheduled to decrease between now and 1993.

The U.S. Forces Korea's ration control system has three objectives (1) to fulfill U.S. obligations under the Status of Forces Agreement, (2) to ensure that adequate supplies of goods are available to meet the needs of authorized consumers and (3) to deter black market activities. Chart 1 shows two of the controls to accomplish these objectives: monthly monetary limits and monthly quantity limits. Additionally some items are specifically controlled such as refrigerators and televisions. And shelf-limits

are placed on the quantities that can be purchased at any one time for certain items. For example, one 25-pound bag of rice, three cans of Spam, and one package of chicken drumsticks.

It is not difficult to spot the signs of black marketing. Large numbers of Korean markets and stores sell duty-free items. Many of the items still have price stickers from the U.S. Forces Korea sales outlets on them.

One such market is Namdaemun. It is one of several shopping areas in Seoul where there are large numbers of individual shops selling U.S. Forces Korea duty-free goods side-by-side with Korean products.

There are "hawkers" on the streets of Itaewon, a shopping area near the Yongsan Army Garrison in Seoul, who sell duty-free goods including American light beer and wine.

Some Korean appliance stores sell a variety of American appliances. In one store we visited, a General Electric refrigerator still had the exchange sticker on its shipping carton.

While we may not be able to precisely measure the magnitude of black marketing, current sales rates for some items popular on the Korean economy, such as rice, Spam, hot dogs, cheese, and hair

spray, indicate the magnitude to some degree. As chart 2 shows, the sales rates for these items are much higher than authorized consumers would normally consume. We saw large amounts of the items being sold on the black market.

To calculate sales rates for most items, we used all of the 70,328 authorized consumers as our universe, not just likely consumers. Chart 3 shows that this universe includes a large number of authorized consumers who have no dependents in Korea. There were 37,428 military members, with no dependents in Korea, who could eat their meals in base dining facilities. Of these 32,927 lived on military bases, mostly in barracks. There were also 3,569 children under 3 years of age. With this in mind, we believe many of our estimated rates are be understated.

Scotch whiskey is very popular among Koreans, and Chivas Regal is one of the most popular brands. It is prevalent on the black market and is the number-one selling liquor at the Class Six stores.

Sales of Chivas Regal in Korea were very high given the number of authorized buyers. As chart 4 shows, we compared overall sales of Chivas Regal and the number of active duty military in South Korea to Chivas sales and the number of active duty military in Europe. On a per capita basis, 46 times more liters were sold in South Korea than in Europe.

Chart 5 shows that the Army and Air Force Exchange Service 1988 shipments of some items to Korea were also very high. There are a number of schemes used by black marketeers to acquire these items and other merchandise. The schemes generally fall into two groups. One group circumvents or works outside the ration control system, and the other works within the established system of controls.

Schemes for circumventing or working outside the ration control system to purchase duty-free items include racetracking, using cashiers and clerks as accomplices, diverting items from the warehouse or showroom, and using fraudulent or altered ration control documents.

Racetracking is when a purchaser makes multiple daily purchases from the same or different retail facilities always keeping the total dollar value of each purchase under $5 to either avoid being recorded in the ration control system or to circumvent shelf limits on items with high demand rates. Racetracking is one of the more visible and blatant violations of the ration control system.

In some locations racetracking is made easier by the retail outlets' location and stockage policy. For example, at Yongsan Army Garrison in Seoul the exchange operates two convenience stores side-by-side and both sell similar products that are in demand on the black market, such as hot dogs and American cheese.

This makes it easier for shoppers to go from one store to another. Another typical black market operation uses cashiers and clerks who work as accomplices with shoppers and either record a purchase amount less than the actual total or record the amount properly, but hide the sales card and destroy it later.

Diversion involves the removal of duty-free items from the retail outlet by employees, usually Korean nationals, for their own use or resale to black marketeers. Usually, the diverted items end up on the black market, although the employee diverting the items normally rings up the retail selling price. It appears like the item was sold legitimately and that no crime was committed. This reduces the chance of generating criminal investigations.

Using fraudulent and altered ration control documents to purchase high value items is common. In this scheme either fraudulent ration control plates are used to make the purchase or the purchaser's actual plate is used and the sales cards are removed from the system.

Our next charts show purchases of high value items made using fraudulent ration control plates. Chart 6 shows that 438 or 5.4 percent of 8,186 items purchased were made using fraudulent plates. Chart 7 shows purchases of certain brand name items using fraudulent plates. The purchases using fraudulent plates ranged from 5.8 percent to 38.9 percent of the total.

The cost of the black marketing can be viewed from two perspectives, cost to the U.S. government and the taxpayer and the cost to the morale of the honest shoppers.

Total sales in Korea for U.S. commissaries, exchange stores, Class Six outlets, and other retail facilities was $250.4 million during fiscal year 1988, as shown in chart 8.[1] While the portion of the sales for black market activities cannot be determined, the estimated appropriated funds support for all sales during fiscal year 1988 was about $35.2 million. Of this amount about $12 million was for ration control, $17.3 million was for transportation cost, $6.3 million was for civilian and military salaries and the remainder was for operations and maintenance costs. We estimate that for every $1.00 spent in U.S. Forces Korea retail outlets on items for the black market, the American taxpayers paid about 14 cents in taxes to support these black marketeers.

In addition to the financial costs to the government, authorized consumers have also experienced anger and frustration. They must cope with a system they know is ineffective in deterring black marketeers. The black market is evident on a daily basis as racetrackers work around the U.S. Forces Korea retail system. Some

[1]This money is used to purchase more goods for resale, build recreational facilities, fund moral and welfare activities, pay employees' salaries, etc.

authorized consumers told us that often the items they want to buy are not available due to black market demand. In addition, the retail outlets tend to overstock items that are in demand on the Korean economy, using shelf space that could be used for other items wanted by the authorized consumers.

These same authorized consumers believe that Korean authorities are not concerned with Korean abusers of the system and therefore that these abusers, who are outside of U.S. jurisdiction, are not being punished. They see black marketing as a moral issue more than a dollars and cents issue. Even if there were no costs to the U.S. government, these consumers would like to see black marketing stopped simply because it is wrong.

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Mr. Chairman, that concludes my prepared statement. We will be happy to respond to any questions.

CHART 1

MONTHLY RATION CONTROL LIMITS
MONETARY LIMITS*

Time period	Family size					
	One	Two	Three	Four	Five	Six or more
July 1987 to current date	$500	$700	$800	$900	$1,000	$1,200

Monthly quantity limits**

Family size	Alcoholic beverages	Cigarettes
One	Four units***	60 packs
Two or more	Seven units	100 packs

* = Limits can be used to purchase all commissary items, all exchange items, or a combination of both.

** = Purchase price does not count against monetary limits.

*** = Unit is a case of beer, or bottle of liquor, which is usually a one liter bottle.

CHART 2

ANNUAL PER CAPITA SALES FOR SELECTED COMMISSARY AND EXCHANGE BLACK MARKET ITEMS

Rice	170 pounds
American Cheese	34 pounds
Bananas	21 pounds
Oranges	20 pounds
Spam	11.75 pounds
Hot dogs	45 packages*
Aqua Net Hair spray	33 cans
Peanut Butter	7.44 jars

* 8 to 10 hot dogs per package.

CHART 3

U.S. FORCES KOREA
AVERAGE PERSONNEL AND DEPENDENTS
1988

TOTAL PERSONNEL			
Military	45,428		
Civilian	4,040		49,468
TOTAL WITH NO DEPENDENTS IN KOREA			
Military	37,428*		
Civilian	1,557	38,985	
TOTAL WITH DEPENDENTS IN KOREA			
Military	8,000		
Civilian	2,483	10,483**	
TOTAL DEPENDENTS IN KOREA			
Military	15,909		
Civilian	4,951		20,860
COMMAND SPONSORED		10,273	
LIMITED COMMAND SPONSORED		7,751	
NON-COMMAND SPONSORED		2,836	
TOTAL PERSONNEL AND DEPENDENTS WITH RATION PRIVILEGES			70,328

* 32,927 live on base, mostly in barracks.

** Total families

CHART 4

TOTAL SCOTCH SALES IN EUROPE

AND

TOTAL SCOTCH ISSUES IN KOREA[a]

Organization	Number of active duty military[b]	Total Scotch liters	Chivas (Liters) Total	Chivas (Liters) 12-year old	Chivas (Liters) 12-year old per capita purchases	Chivas (Liters) 21-year old
U.S. Forces Europe	305,947	228,140	48,615	47,085	0.15	1,530
U.S. Forces Korea	45,501	496,596	334,008	314,748	6.93	19,260

Note[a] Table compares fiscal year 1988 U.S. Forces Europe (Army and Air Force only) sales versus U.S. Forces Korea calendar year 1988 issues to stores for sale because fiscal year 1988 U.S. Forces Korea sales data were not available.

Note[b] As of September 30, 1988.

CHART 5

AAFES' 1988 SHIPMENTS OF SELECTED ITEMS DESIRED BY BLACK MARKETEERS

Type of item	Number Sold	AAFES' Cost
Irons	49,177	$ 579,121
Toasters	42,563	$ 463,936
Corning Visionware Dish Sets	35,079	$ 822,072
Video Cassette Recorders	18,022	$ 5,040,844
Television Sets	12,065	$ 4,444,145

CHART 6

Purchases with Fraudulent Ration Control Plates
September 1, 1988 to April 15, 1989

Type of item	Total number purchased	Purchased with fraudulent plates	
		Number	Percent
Washers	150	39	26.0
Refrigerators/freezers	456	111	24.3
Ranges	129	15	11.6
Dryers	31	2	6.5
Music systems	1,134	72	6.4
Speakers	1,768	72	4.1
Televisions	2,461	97	3.9
Video recorders	2,057	30	1.5
Total	8,186	438	5.4

CHART 7

Selected Items Purchased at Yongsan with Fraudulent Ration Control Plates
September 1, 1988 through April 15, 1989

Item and unit price	Total number purchased	Purchased with fraudulent plates	
		Number	Percent
GE washers ($435)	90	35	38.9
GE refrigerators ($1,150)	118	38	32.2
GE refrigerators 19.6 ($680)	91	29	31.9
20" Sony televisions ($479)	78	20	25.6
GE refrigerators 17.7 ($560)	107	26	24.3
Magic Chef 30" ranges ($425)	67	12	17.9
27" Sony televisions ($930)	128	20	15.6
40" Pioneer televisions ($2,195)	34	5	14.7
Admiral refrigerators ($895)	49	7	14.3
25" Sony televisions ($920)	255	33	12.9
Kenwood music systems ($1,130)	189	17	9.0
Magic Chef 20" ranges ($350)	52	3	5.8

Note: Refrigerator sizes are shown in cubic feet, where known.

CHART 8

SALE COMPARED TO
APPROPRIATED FUNDS
SUPPORT

FISCAL YEAR 1988

TOTAL SALES			
Commissary		$ 86,900,000	
$250,442,000			
Exchange		150,182,000	
Class Six		13,160,000	
TOTAL APPROPRIATED FUNDS			$35,160,000
RATION CONTROL SYSTEM	$ 12,035,509		
TRANSPORTATION		$ 17,310,000	
Commissary		$ 12,173,000	
Exchange		4,651,000	
Class Six		486,000	
PERSONNEL			
Commissary		$ 6,333,000	
OPERATIONS AND MAINTENANCE			
Commissary		$ 82,000	
APPROPRIATED FUNDS PER SALES DOLLAR			$ 0.14

STATEMENT BY

COLONEL WILLIAM D. HUGHES
DEPUTY ASSISTANT CHIEF OF STAFF, J1
HEADQUARTERS, UNITED STATES FORCES, KOREA

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

BLACK MARKET ACTIVITIES IN SOUTH KOREA

19 OCTOBER 1989

NOT FOR PUBLICATION
UNTIL RELEASED BY
SENATE GOVERNMENTAL
AFFAIRS COMMITTEE

25-231 - 90 - 3

UNITED STATES FORCES, KOREA STATEMENT FOR RECORD

ON

BLACK MARKET ACTIVITIES IN SOUTH KOREA

Mr. Chairman and Members of the Subcommittee.

I appreciate the opportunity to discuss efforts by U.S. Forces, Korea (USFK) to combat blackmarketing. We do not condone blackmarketing. We are committed to honor our obligations under the ROK-US Status of Forces Agreement to control duty-free goods. We also have a moral obligation to our service members, DoD civilian employees, and their family members to provide a good quality of life. This includes ensuring products are reasonably available to authorized patrons of the commissaries and exchanges. We also try to minimize restrictions limiting purchases while still honoring our obligations. The General Accounting Office's review of blackmarket activities in South Korea was very useful to us in fine-tuning the ration control system. We are continually looking for ways to improve the system while maintaining a good quality of life for all.

I will discuss blackmarketing in Korea and explain the current ration control system designed to assist the command in combatting blackmarketing by its members. I will address the responsibilities

of commanders, retail facility managers, law enforcement agencies, Public Affairs, the proponent for ration control, as well as individuals assigned to USFK and their family members. I will briefly discuss costs for the ration control system, as well as highlight recent initiatives to improve the command's effort in combatting blackmarketing. I will discuss plans for an automated ration control system that will capture sales data at the point of sale, electronically. I will also provide USFK comments on GAO observations during their review of blackmarket activities in South Korea.

The blackmarket in Korea has existed ever since U.S. forces have served there. The Republic of Korea Government (ROKG) and its economy, both domestic production and importation of foreign goods, appear to lack the capability to totally satisfy the demand by the Korean people for quality goods in sufficient quantities at reasonable prices. The demand is for a large variety of consumable goods, and durable merchandise. Although the Korean economy can produce many of these goods, it is not producing all of them yet. The demand will probably continue to exist in the near future although it is expected that the demand will ultimately be satisfied through either domestic production or imports. High Korean taxes currently make products sold in USFK retail facilities extremely attractive. One other aspect of the demand is that foreign produced goods, particularly those produced in the U.S., are often considered to be of a higher quality.

We have employed various methods to reduce blackmarketing. A ration control system was established near the end of the Korean War. Various versions of ration cards or coupon books that had to be marked, punched, or have a coupon withdrawn were employed. These manually controlled systems were effective for only short periods of time because cards or coupons were easily transferable or counterfeited. To aid the command in identifying individuals who abused the ration control system, a computerized ration control system was established in 1971.

The computerized system is called the Command Unique Personnel Information Data System (CUPIDS). This system is a Korea-wide database which provides ration control accounting, purchase histories, violation data, and demographic data covering all US military and civilian personnel and their family members residing in Korea. In addition to the ration control aspects of CUPIDS, the database is the primary tool supporting noncombatant evacuation operations in case of war by providing complete information on all US noncombatants who would be evacuated. The database is also used extensively for studies which impact service members, civilians, and their family members in areas of logistic support. The ration control accounting subsystem of CUPIDS, although antiquated, labor intensive, and in need of upgrade, is more effective than other methods previously employed in this command. This system uses both a paper, temporary ration card with preprinted limits for dollar,

liquor, beer, and cigarette purchases that are lined out as the purchases are made, and a permanent plastic ration control plate (RCP) that is very similar to a credit card. Purchases made with a RCP are recorded on forms similar to those used to record credit card purchases. The process of recording the purchase and embossing the RCP onto the form is called "anvilling." It offers the smallest amount of inconvenience for our personnel, while providing a deterrence to individuals inclined to engage in blackmarket activities. The Ration Control System limits or deters blackmarket activity in the following manner:

a. Purchasing limits. There are monthly limits on how much an individual or family can spend and in the number of specified items an individual or family can purchase from our retail outlets. These limits are a dollar ceiling covering most consumable goods as well as specific quantity limits on alcohol and cigarettes. Limits are as follows:

FAMILY SIZE	DOLLAR LIMITS	ALCOHOL LIMITS	CIGARETTE LIMITS
* 1	$500	**4 Units	60 Packs
2	$700	7 Units	100 Packs
3	$800	7 Units	100 Packs
4	$900	7 Units	100 Packs
5	$1000	7 Units	100 Packs
6 or more	$1200	7 Units	100 Packs

* Includes noncommand sponsored families (family members brought to Korea at the member's own expense) on one year tours, regardless of family size.

** An alcohol unit equals one case of beer or one quart/fifth of liquor. Partial units are rounded up at the end of the month.

b. Identification/controls on purchasing high value, durable goods. We have imposed controls on 16 categories of high value, durable goods in high demand on the black market. These items include:

Cameras
Color TVs/monitors
Stereo music systems or components
Speakers
Video cassette recorders
Diamonds or jewelry with diamonds
Watches over $100
Microwave/convection ovens
Washing machines
Clothes dryers
Ranges
Refrigerators and freezers
Crock pots/slow cookers
Golf club sets
Single items not listed above that cost $100 or over

A paper and/or electronic record is created and maintained whenever an individual purchases one of the above listed items. A commander can request a printout of purchases made by an individual assigned to his unit. During the last six months of assignment to Korea, an individual's commander will review the high value roster to determine if an individual has purchased multiple high value items of the same type or many high value items of various types. If the individual has, he/she may be asked to account for all high value items purchased.

Lower ranking personnel (enlisted personnel in the grade of E5 and below, and DoD civilians in the grade of GS-5 or below) and transient personnel require additional approval from their unit Ration Control Responsible Officer to purchase the above listed items. Some young service members are lured into blackmarketing by seasoned professionals who offer the promises of making large amounts of money. Requiring the unit commander or Ration Control Responsible Officer to approve their high value purchases provides some deterrent to these young service members.

c. Another way we prevent blackmarketing is by imposing shelf limits on high demand products. That is, we try to limit the quantities that may be purchased on a single day in order to ensure that all authorized patrons have the same opportunity to obtain products they need for their personal consumption. A single day's sampling of shelf limits we might employ could limit the customer

to two 8 ounce jars of instant coffee, three 6-packs of fruit juices, one jar of peanut butter, one bag of rice, and two cases of soda. Commissaries impose a limit of six on items not otherwise controlled by specific shelf limits. Store managers, installation commanders, and ration control managers may impose shelf limits. Shelf limits apply to all ration card holders. While this system is not perfect, as it prevents our personnel from legitimately stocking up on items perceived to be in short supply, we employ the system in order to discourage the minority who try to purchase more items than they can personally consume -- for the purpose of resale on the local economy.

The ration control system relies on many agencies to operate efficiently. Retail store managers and unit commanders are among the most important. Store managers are responsible for implementing command-directed controls. These controls include: comparing the patron's identification card and ration control plate (RCP) or temporary ration card to ensure the SSN is the same on both; reviewing unique data on the RCP, such as card expiration date; and ensuring the individual is authorized to enter and purchase from the facility. This procedure is accomplished at store entrance at large facilities and is also required to be accomplished at the cash register in all stores prior to purchase. Cashiers must ensure an individual is authorized to make a purchase, e.g., has an L on the RCP to purchase beer or liquor, or an I on the RCP to purchase high value durable items, or a B on the RCP to purchase baby items.

If the individual is purchasing alcohol or cigarettes, high value items, or the total purchase is $100 or more, the cashier must also check the Lost/Stolen RCP report to ensure the card being used is not listed. The cashier is also responsible for recording the purchases against the appropriate limit. They do this by separating items into four groups which are recorded against dollar limits, quantity limits (alcohol or cigarettes), controlled (high value items mentioned earlier), or are ration-free. Ration-free items include clothing, footwear, military uniforms, fabric by the yard, and wine and wine coolers. Different forms are used to record items purchased or refunded. One form is used to record high value items (purchased or refunded). After capturing the data recorded thereon electronically, this form is sorted by SSN and provided to the USFK Provost Marshal for storage. A different form is used to record all items that count against the dollar or quantity limits. A third form is used for refunds of items that count against the dollar or quantity limits.

Commanders are responsible for many areas of the ration control system. Their responsibilities include: in-processing newly assigned individuals (filling out RCP applications, issuing temporary ration cards, providing a briefing which explains the individual's limits, how to read anvil (sales) cards, controlled (high value) items, and the policy on disciplining system abusers); issuing permanent RCPs upon receipt; issuing Letters of

Authorization Purchase Record to E5/GS-5 and below personnel; reviewing and approving/disapproving requests for short-term exception to policy or limits; investigating lost/stolen or confiscated RCPs; and taking action regarding the excess purchase rosters. Commanders are also responsible for disciplining system abusers. We have published command guidance on expected levels of administrative sanctions to be imposed for violating the ration control regulation. Recommended guidelines for administrative sanctions for exceeding dollar or quantity (alcohol or cigarette) limits are as follows:

First Offense - Verbal or written counselling.

Second Offense within a 2 year period - written counselling or letter of reprimand and a reduction in the privilege that was exceeded.

Third Offense within a 2 year period - letter of reprimand and withdraw the privilege (alcohol or cigarettes only) that was exceeded for a maximum of one year or until individual departs Korea. If the dollar limit was exceeded, reduce the limit.

Fourth Offense within a 2 year period - revoke all privileges for one year or until individual departs Korea, but allow subsistence privileges.

Guidelines for administrative sanctions for circumventing the ration control regulation by making multiple daily purchases to avoid shelf limits or recording sales transactions are as follows:

First Offense - Revocation of all privileges for a six month period for the individual who violated the ration control regulation. Subsistence privileges may be provided.

Second Offense within a 2 year period - Revocation of all privileges for the individual for a one year period. Installation commander should overstamp ID card to indicate revocation of PX and commissary privileges.

Third Offense within a 2 year period - Same as that for second offense, with the addition of debarment from all U.S. Forces, Korea installations except for access to medical facilities. Commanders should consider early return of dependents if dependents are involved in violations, and a bar to reenlistment for service members involved in violations.

The guidelines are not intended to dictate mandatory actions or to limit commanders' prerogative, but are established to indicate the normal level of sanction to be used for repeated violation of ration control limits. Additional sanctions may be imposed if warranted.

Sanctions include: UCMJ action for service members; termination of employment for civilian emplcyees; and removal of accreditation for invited contractors or technical representatives. Mandatory revocation of privileges is required when a sponsor exceeds his/her dollar limits by $200 or more, or exceeds his/her quantity limits on alcohol or cigarettes by 100% (purchases 120 packs of cigarettes but only authorized 60 packs). Additionally, if an individual exceeds the ration control limits and is reassigned from Korea prior to discovery of the violation, the former commander in Korea may forward a memorandum to the individual's gaining commander to ask that appropriate action be taken. This serves to deter individuals who violate their limits during the last 60 days of assignment in Korea.

Law enforcement agencies are integrally involved in deterring blackmarketing. They investigate lost and stolen ration control documents and forms. The Provost Marshal, USFK, prepares and distributes lists of lost, stolen, or counterfeit RCPs to retail facilities. Additionally, the Provost Marshal, USFK, maintains a file of controlled item sales cards of high value items purchased in retail facilities; advises the command on blackmarket trends and current patterns; and is the focal point for the command's ration control enforcement program. Joint Blackmarket Suppression Teams consisting of military police investigators and Criminal Investigation Command agents operate throughout the command.

They are involved in over 200 investigations or cases per year in an attempt to identify and apprehend personnel involved in serious blackmarketing. The Air Force Office of Special Investigations and Army Criminal Investigations Command are involved in both covert and overt operations to deter blackmarketing. They concentrate on cases that involve organized blackmarketing.

Public Affairs Office (PAJ), USFK, prepares numerous articles, fact sheets, and a pamphlet on ration control and blackmarketing. Additionally, education on prohibited activities and consequences of getting involved in blackmarket activities are topics that receive command-wide publicity. Annually, PAJ publishes an information pamphlet that is given to all newly assigned personnel. This pamphlet educates the individual on his/her ration limits, items that are controlled (high value items) and must be accounted for, the importance of keeping records, and a warning about getting involved in the blackmarket.

J1 Data Management keeps sales data. Sales cards are picked up from the retail facilities each week by a representative of the installation commander and forwarded to J1 Data Management. Data on these sales cards are recorded, and, after the end of the month, sales cards that document over-purchases are hand-validated by J1 Data Management and filed for use as evidence of the over-purchase. Approximately 400,000 sales cards are received monthly. On average,

1500 sponsors violate their ration limits each month. This represents about 3.4% of the sponsors authorized ration privileges. Many of these violations are minor and are committed by service members who do not realize the importance of staying within their ration limits. Data from the high value sales cards are also recorded by J1 Data Management. Reports generated from this data are provided to commanders and law enforcement agencies to identify and stop individuals who may be routinely purchasing above their personal or family needs. Examples of some of these reports include: the limitation excess purchase rosters; previous history of excess purchases; LOA/high value rosters; and numerous reports indicating the top buyers of particular merchandise, such as high value items, coffee, etc. J1 Data Management also provides commanders with sales summaries which provide information on items purchased over the past year, including all controlled item purchases. Commanders also request ration control checks on personnel they are considering for awards or extensions of foreign service tours (FST). Committing a ration control violation does not exclude an individual from receiving an award or a FST extension, however, violations may influence command action in granting or denying the award or extension. Another important function of the J1 Data Management staff is producing the RCPs.

As mentioned by GAO in their Exit Conference Discussion Paper on this subject dated 3 May 1989, J1 Data Management produced 76,987 RCPs in 1988. Given the yearly rotation of USFK personnel and the

funds are used to procure commissary items and because alcohol and tobacco products are sold free of state and local taxes. We do not intend to jeopardize military benefits by allowing unscrupulous people to make a profit at the expense of the U.S. taxpayer and service members in general.

The costs of the ration control system were provided to Congressmen Leath and Martin in August 1988. This command reported the total costs for operating the ration control system were $13,026,805 for 1987. Personnel costs were as follows:

Direct costs: $3,158,196 (includes J1 Data Management staff, personnel to type information from the applications or from sales cards that could not be read by the optical character recognition computer, law enforcement investigators, store monitors, and personnel working in the 19 Ration Control Issuing Agencies)

Indirect costs: $9,362,188 (These are costs associated with complying with the ration control regulation. This includes individual's time or commanders' and clerical time that will not result in a reduction in personnel if the ration control program was discontinued. These personnel would continue in their present jobs.)

need to replace broken, lost, stolen, or incorrect RCPs, this number is reasonable to support our 45,000 plus sponsors and their family members. Applications for RCPs are filed on all personnel authorized a permanent ration control plate and kept until 3 months after they are no longer authorized privileges or have departed Korea. J1 Data Management is authorized a staff of 4 computer operators, 5 computer programmers, a Department of the Army civilian in charge of the Automated Data Processing Branch, 7 administrative specialists/assistants, a policy officer, a NCO and officer in charge (OIC) of the division, plus a secretary for the OIC and a Korean National clerk.

Personnel authorized ration privileges play an important role in making the ration control system effective. They are required to keep track of their purchases and ensure their family unit stays within monthly ration limits. They must also comply with regulations that govern disposition of duty-free products as well as be aware of the prohibited activities that are outlined in the ration control regulation. Many of these prohibited activities are the same for personnel authorized commissary and exchange privileges in the Continental United States. For example, members are prohibited from purchasing commissary items, cartons of cigarettes or packaged alcoholic beverages from military facilities and reselling them or giving them away to persons not authorized to purchase such items. These prohibitions exist because appropriated

The following direct costs were also provided:

Supplies: $397,196
(includes forms, RCPs, supplies used by J1 Data Management, etc.)

Equipment: $4,725
(includes the machines that imprint the RCP onto the sales forms)

Contract: $104,500
(includes maintenance contracts for the optical character recognition computer and the RCP embossing machines)

Of the above costs, less than $1 million per year is spent in OMA funds. The balance is personnel costs spent by the Army, Navy, and Air Force. Most of these costs are for time spent by personnel administering or complying with ration control as an additional duty. They include: costs for commanders to implement ration control policies, educate unit personnel, and discipline system abusers (MPA funds); costs for administrative personnel to complete ration control applications and issue ration cards (MPA funds); costs for retail facility personnel to implement the ration control procedures (Army Troop Support Agency (MPA, OMA), Air Force Commissary Services (MPA, OMAF), AAFES (NAF), and various other nonappropriated fund activities); and the costs for approximately 45,000 sponsors who spend a small part of their time complying with ration control requirements. Commanders and administrative personnel

positions would not be eliminated even if the ration control program was discontinued.

We have reemphasized the importance of ration control and have recently issued a series of policy directives to limit blackmarketing. We reduced the amount of purchases excluded from counting against the sponsor's dollar limit from $5 to $2 effective 1 July 1989. This change was needed because many unscrupulous people made multiple daily purchases under $5 to avoid having these purchases recorded against their monthly dollar limits. This is a practice called "racetracking." Racetracking was openly done and caused a public outcry at community forums. Reducing the amount recorded to $2 has dramatically reduced this visible irritant as well as made it more difficult to circumvent ration control dollar limits. We had raised the amount recorded against the dollar limit from $1 to $5 on 1 July 1987 to reduce the number of anvil cards processed through the Optical Character Recognition computer as well as improve the timeliness of excess purchase rosters. The number of cards processed, however, did not drop significantly due to a concurrent increase in the dollar limits for all family categories. Second, we published guidelines for normal levels of administrative sanctions to be imposed for violating ration control limits. These sanctions were explained earlier and became effective 1 July 1989.

Third, we changed the manner in which an individual has to account for the high value items he or she purchases. The change brought USFK accountability procedures in line with a court decision affecting an individual's right against self-incrimination. The change requires commanders to review an individual's record of high value purchases at least six months prior to departure from Korea. If the individual is unable to account for any apparent abuses of the ration control system, then administrative sanctions may be imposed immediately. Fourth, retail facility managers have been instructed to ensure their employees comply with the requirement to check the Lost/Stolen RCP report. Store employees who sell high value items, beer, liquor, or cigarettes to a person using a RCP on this report are being identified and the retail facility is required to provide additional training or take appropriate action for those employees who continuously accept RCPs on the Lost/Stolen RCP report. Lastly, installation commanders were instructed recently to ensure they comply with the requirement to forward sales cards to J1 Data Management in a timely manner so that they arrive before the cutoff date for the sales month.

We are also concerned about long-term blackmarketing and ration control. Presently, we have dedicated a project officer to defining, developing, and implementing an upgrade to the current automated ration control system. Initially, we are considering a point of sales (POS) system similar to the system which was funded and is being installed for Southern Command in Panama. Numerous problems

have been identified with the current automated system, which we plan to fix with a point of sales system. If funded, the POS system will be installed in AAFES and commissary retail outlets throughout USFK. We will require the POS system to screen and identify lost, stolen, and counterfeit cards, and preclude purchase with those cards. Presently, it is possible to make purchases with those unauthorized cards because detection of them is difficult. We plan to be able to identify violators the day after a violation occurs, because of the electronic transfer capability. Presently, violators are identified after sales transaction information has been processed, which is about 25 days after the end of a calendar month. The proposed POS system will also be able to identify individuals who are purchasing significantly more of a single item than could be reasonably consumed. For example, for customer convenience, present shelf limits allow a purchaser to buy six bottles of shampoo at one purchase. As you can see, an individual could purchase up to 162 bottles of shampoo a month if they shopped in the commissary once a day. The POS system would identify individuals who abuse their privileges in this manner.

The following are USFK comments to GAO observations and items for USFK to consider that were contained in the GAO Exit Conference Discussion Paper on Black Market Activities in South Korea, dated 3 May 1989:

Weaknesses in the Ration Control System:

a. GAO commented that violator reports are not timely and unit commanders may receive reports several weeks after a violator has left Korea. As with any system having monthly limits, reports cannot be generated until the month is over. As an exception, J1 Data Management has in the past produced unverified gross violator reports based on sales data during the current month. Commanders were notified that they may have an individual in their unit who is grossly violating ration limits. However, verified violator reports take approximately 30 days after the end of the sales month to produce and be ready for distribution. This allows time for installations that are not in close proximity to J1 Data Management to forward the sales cards to arrive NLT the 5th work day of the following month. Commanders can and do take action on violators who have departed Korea. If violators are still in the military service or employed by Department of Defense, a memorandum to the gaining commander or activity explaining the violation and requesting that appropriate action be taken is encouraged.

b. GAO stated that high value items purchased with temporary ration cards are not entered into the J1 Data Management system. This is true, however, the high value sales cards are sorted by SSN and forwarded to the Provost Marshal, USFK, for use in controlled item inventories or as evidence of purchase. Making a record of

temporary ration card high value item purchases is possible, but extremely costly. Additionally, many of the sales cards would be on personnel no longer in the command. The end result would be a number of unmatched records, because of no record of the individual in the database.

c. GAO commented that retail stores and MWR activities do not send their anvil (sales) cards to J1 Data Management by the monthly cutoff date. We have, as mentioned earlier, pointed out the responsibilities of the installation commander to ensure sales cards are delivered to J1 Data Management in a timely manner.

d. GAO observed that the U.S. does not have the authority to prosecute Korean nationals for blackmarketing and even has difficulty firing Korean national employees who have been caught blackmarketing, due to opposition from strong Korean labor unions. USFK does not have the authority to prosecute Korean nationals for violations of either ROK or US law. However, we do not have difficulty firing Korean national employees who have been caught illegally transferring duty-free goods to persons not authorized this privilege. The unions do not involve themselves in these cases unless the evidence supporting the removal is weak.

e. GAO also commented on the substantial number of high value items that were purchased using fraudulent RCPs. As mentioned earlier, we are identifying store clerks who accept RCPs listed on

the Lost/Stolen RCP report. We previously provided this information to law enforcement agencies and now provide it to commanders of retail facilities beginning in July 1989.

GAO provided USFK with a listing of items to consider. They include:

a. Eliminate ration privileges for noncommand sponsored dependents: We do not support this as we feel it will degrade noncommand sponsored dependents' quality of life. We believe we have a moral obligation to take care of our dependents. Most of these dependents are of Korean descent and come to Korea at their own expense. They will continue to come, whether they receive ration control privileges or not. Requiring the sponsor to do all the shopping simply degrades morale and readiness.

b. Institute ration control monitors, possibly on a volunteer basis: We withdrew ration control monitors at the end of Fiscal Year 1988 due to severe budget constraints that have not eased and are not projected to ease. Adequate measures are in place to ensure integrity of the ration control system in the absence of these monitors. Accepting voluntary ration control services violates 31 U.S.C. section 1342.

c. Install TV monitors at PX and commissary checkouts to observe and crackdown on sweethearting (collusion between the patron and the cashier): Some of the major retail facilities in Korea are in the process of installing camera systems, with installation to be completed by 1 Oct 89.

d. Anvil all products sold at the Class Six stores: We are considering this proposal.

e. Increase publicity on punishments for violators and blackmarketeers: We agree that appropriate level of publicity on punishments dealt to ration control violators is an important part of the blackmarket deterrence program. However, moderation and careful judgment must be exercised to avoid the perception that a "crime wave" exists within USFK. Internal press releases tend to be picked up by the ROK press to support their contention that American personnel disregard ROK law, because the Status of Forces Agreement makes them all but immune to ROK law. North Korea picks up on this report and distorts it even further to assert the South is a puppet of the U.S.

f. Work with the ROKG to ensure compliance with SOFA provisions regarding customs requirements: We continually seek the cooperation of the ROKG to close down the demand side of blackmarketing. We do this through the SOFA's Ad-Hoc Subcommittee on Illegal Transactions in Duty-Free Goods. This committee meets to resolve customs related issues identified by either the U.S. or ROK.

In summary, We are very serious about controlling blackmarketing by its members. To do this requires a ration control system that is convenient and achieves the primary objective of controlling duty-free goods. A new version of an automated ration control system that captures data at the point of sale and forwards that data by the end of the work day would be extremely effective in combatting blackmarketing. Being forced to return to paper-type ration cards for all personnel because of budget cuts would be a step backwards. We have had various types of paper cards, all of which are susceptible to counterfeiting or "sweethearting." Until it becomes unprofitable to purchase products sold at USFK facilities for resale on the blackmarket, we believe that a ration control system will be necessary to meet our obligations to control duty free goods.

Army and Air Force Exchange Service (AAFES)

Statement of Record

on

Black Market Activities

in South Korea

By

Colonel James B. Donahoe, USAF

Commander

Army and Air Force Exchange Service - Pacific

Mr. Chairman and Members of the Subcommittee

I'm Colonel James B. Donahoe, Commander of the Army and Air Force Exchange Service for the Pacific region. I appreciate the opportunity to meet with you and discuss a matter of vital concern to the Army and Air Force Exchange Service. I am responsible for all exchange retail operations which are better known as either the PX or BX. We serve all Army, Air Force, Navy and Marine Corps assigned to Korea. In our fiscal year 1988 we sold $150 million in merchandise at our military installations across Korea. With a customer population of approximately 67,000 members consisting of active duty, DOD/Department of State civilians and dependents, our sales equate to a per capita spending of $186 per month for each authorized customer.

As the largest military retail sales organization in Korea, we are vitally concerned with black marketing and ration control issues. In Korea, black marketing is a highly emotional issue that is often misunderstood along with its impact on our customers. Today, I'd like to try to put the issue in a rational, factual perspective.

I would like to explain the mission of the Exchange Service and how it differs from the commissaries. Commissaries are located on major military installations in Korea. They operate with appropriated funds and all commissary employees are paid through appropriated funds. On the other hand, the exchange is a nonappropriated fund activity and is nearly self-supporting. We provide merchandise to our customers at the same price they would pay in any of our CONUS stores. These prices are established to pay for all costs to

bring the goods to the point of sale -- and then to generate a small profit of approximately 4%. Half of these profits are then used to support morale, welfare and recreation (MWR) facilities and activities for our troops -- a cost that would have to be borne by the taxpayers if the exchange did not exist. These programs include such programs as gymnasiums, libraries, sports programs, etc. Most of our earnings are paid at the Department of Army and Air Force levels. However, in addition to payments at the headquarters level, we also returned $4.3 million direct to the Army installation commanders in Korea through August of this year. The other half of the profits are used to improve AAFES facilities. This improves services to our customers and ensures a long-term earnings base for military MWR programs.

Like any other business, we measure our operations in sales and earnings. But the most important part of our business is customer service and improving the quality of life for every service member in Korea. The reasons are simple: (1) It's good business and (2) Payback to DOD and the U.S. taxpayer is significant. If we can eliminate some of the hardships of serving in a distant foreign culture, the individual is more likely to remain in the military. To keep only one fighter pilot for a career would provide a savings of $6 million in training a single replacement to the same level of proficiency. Retaining trained and experienced fighting personnel provides immediate, tangible savings -- and exchange and commissary services are key players in that process. Therefore, we try to offer our customers the same atmosphere, merchandise, price and convenience they would find in a Stateside assignment. We want our stores to look, feel and operate just like a Stateside PX to offer

that essential "taste of home." Unfortunately, the small fraction of our customers who violate the Korean Customs laws have driven development of extensive ration control procedures which do affect our level of customer service.

Today I would like to show you the extensive procedures we employ in supporting the U.S. Forces Korea ration control procedures.

Basically, there are two ways in which merchandise winds up on the black market. The first method is through "diversion." In this instance, the employee takes the merchandise from the exchange. Historically, when Korean employees surreptitiously remove merchandise from the store, they have put money in the cash register to pay for the merchandise. At this point, they violate ration control procedures and the Status of Forces Agreement in making an illegal purchase. Our Korean employees are not allowed to purchase retail merchandise from the exchange. When the employee sells this merchandise off-base to another unauthorized customer it becomes black marketing and violates Korean customs laws. The employee's profits are based on the difference between the exchange purchase price and what he received from the off-base sale. The Exchange Service does not condone this process in any form or fashion.

We have been very vigilant in trying to detect diversion and have dedicated extensive resources to stop this practice. In addition to our normal internal security organization, we established a separate Merchandise Security Office

(MSO) in 1980 whose sole function is to look for diversions and other illegal transfers of merchanidse (including employee theft). The cost of our total security effort is borne by our customers.

Internally, we have both overt and covert surveillance programs to detect theft and diversion. We also work with the Army's Criminal Investigation Division and the Air Force's Office of Special Investigations and the Naval Investigative Service on a daily basis. Our organizations detect diversions as a result of anonymous tips, informers, covert surveillance operations, review of accounting procedures, audits of unusual issues or purchases and general oversight of the business operations. Over the past three years we have apprehended 88 Korean employees engaged in diversion or collusion in black marketing. Unfortunately, we have had instances where our employees have been in collusion with customers to avoid recording sales in the ration control system. Our normal punishment for individuals found guilty of either diversion or collusion is separation. To date, the Korean government views diversion as a "victimless crime" and has not actively prosecuted employees separated for diversion. In some recent cases, they have levied heavy fines for circumvention of customs duties.

The common definition of black marketing is when the customer buys merchandise from AAFES and resells it to unauthorized individuals. I must emphasize that in both the exchange and the commissary we sell only authorized merchandise to authorized customers. The purchases are legal as long as the individual remains under his or her ration control limits and is authorized to buy that particular merchandise. If the customer then sells the merchandise to an

unauthorized customer and keeps the profit gained from this illegal sale -- then the act is defined as black marketing. In Korea we also use another peculiar term called "racetracking." Under the ration control rules, purchases under $2.00 are not recorded. This is to reduce the administrative burden of maintaining the ration control system. Prior to July of 1989, purchases under $5.00 were not recorded except for "controlled" items. Individuals known as "racetrackers" can make purchases at several stores. If each purchase is under $2.00, the amounts are not recorded in the ration control system. The individual, through numerous trips, could accumulate some merchandise and not have it recorded against their ration control limits. This process is legal -- until the merchandise is sold on the black market.

We firmly believe a ration control system is needed to prevent the wholesale transfer of goods to the Korean market. Our Status of Forces Agreement with Korea requires us to "take reasonable and prudent measures" to control merchandise which is exempt from Korean taxes. I believe we have a moral obligation to support this agreement made with our host country.

To minimize black marketing, U.S. Forces Korea has developed extremely detailed procedures to control and record the merchandise sold in exchanges and commissaries. These procedures limit, in dollar-terms, the amount of merchandise that may be purchased and restrict the sale of items which are popular on the black market. As a military instrumentality, we follow these procedures. To demonstrate how extensive the procedures are, let me walk you through the process required for every purchase by every customer.

Step 1 - We check the individual's ration control plate and military ID card. Every authorized customer in Korea is issued a ration control plate (similar to a credit card) which identifies the individual and their PX/BX shopping privileges.

Step 2 - If the purchase will be greater than $100 or contains a high-value item, we then check through our master list to see if the card has been reported as lost, stolen or counterfeit.

Step 3 - We then check the ration control plate to determine the categories of merchandise authorized for that individual. For example, only individuals with a baby in the household are authorized to purchase baby products and would have a "B" marked on their ration control plate. Without this "B," you cannot purchase any baby products such as baby food, formula, diapers or shampoo.

Step 4 - We then divide the merchandise into categories. If the individual has purchased alcohol or cigarettes, these must be recorded individually on a form similar to a credit card voucher. This voucher is then imprinted with the member's ration control plate -- a process commonly referred to as "anvilling."

Step 5 - We then check to see if the individual has any high-value goods. These would be items ranging from TVs and VCRs to household appliances such as rice cookers or crock pots. For junior enlisted and civilian graded personnel, they must have a letter of authorization from their commander to

purchase these individual items. These items are also individually recorded on a form and do not count against the member's monthly dollar limit. Prior to leaving Korea, the individual must account for all of his or her purchases of high-value items.

Step 6 - We then see if the individual has any special interest items (e.g., laser videos, compact disks, cases of audio or video tapes or any single items over $50). If so, then we record the specific item on another voucher and imprint it with the member's ration control plate.

Step 7 - Other popular items on the black market have designated shelf limits. These limits may be set by each installation commander and vary from installation to installation -- depending on the local popularity of these items. For example, at some installations, an individual may purchase only two cans of hair spray per visit. If the individual has more than the shelf limits of any of these controlled products, the merchandise is returned to the shelf.

Step 8 - We then record the total amount of the sale on a separate voucher. This general merchandise then counts toward the individual's monthly limit. That limit is the total that can be spent in commissaries and exchanges. It varies proportionately with the number of members in the household. For example, the limit for a single service member is $500/month. For a family with two children, the limit would be $900/month.

Step 9 - We then segregate those items which are designated as "ration free." Items such as clothing and athletic shoes, which have no commercial value on the local market, are exempt from the ration control limits.

Step 10 - We then take all the forms generated in this process for handling one customer, and place them in sealed containers. The forms are then collected monthly and sent to U.S. Forces Korea for processing.

The procedures I've just described generate over 400,000 forms per month for processing. The processing then generates reports and identifies apparent violators. The reports are then sent to the individual's respective commanders.

Regardless of how detailed the procedures, or the limits placed on our individual service members, I expect some merchandise will reach the black market. I believe under the current procedures, the amount is minimal in comparison to our total sales.

There is, however, a real danger in trying to tighten the controls to the extent where no merchandise reaches the black market. If we truly restrict all avenues of supply, and the Korean government did nothing to reduce the demand, we would be subject to an elementary law of economics. With low supply and high demand, the price rises and becomes a much greater temptation for more people, including our own employees, to take the risk and divert merchandise to the black market. In years past, when anti-black marketing efforts have been intensified and reduced the supply side, we've seen more and greater attempts to divert merchandise. In fact, when closing in on major

diversionary activities, we have had several stores and all their records burned or destroyed. The real loser then becomes our customers who must pay for the store replacement or do without the facilities and convenience.

Black marketing is a difficult problem. For the military to solve it alone would require harsher controls and greater punishment. The secondary impacts on morale, retention and quality of life may outweigh any savings realized.

We will continue to work with U.S. Forces Korea to reduce the flow of goods to the black market. The ration control system we have in place to accomplish this is not perfect. But it is reasonably effective in minimizing the flow of goods to the black market without forcing our customers to live in an unreasonably controlled environment.

I would urge you not to impose any additional, artificial controls on the system. I can assure you that we in the exchange are working closely with U.S. Forces Korea officials to eliminate diversion wherever we may find it. We are endeavoring to follow the prescribed ration controls while trying to minimize inconvenience to American military personnel and their dependents assigned to overseas areas.

Thank you.

TESTIMONY OF SANDRA KRISTOFF
ASSISTANT UNITED STATES TRADE REPRESENTATIVE
FOR ASIA AND THE PACIFIC
BEFORE THE
THE SUBCOMMITTEE ON GOVERNMENT OVERSIGHT AND MANAGEMENT
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
OCTOBER 19, 1989

MR. CHAIRMAN, I AM PLEASED TO APPEAR BEFORE YOU AND THIS SUBCOMMITTEE TODAY WITH MY COLLEAGUES FROM THE DEPARTMENTS OF DEFENSE AND COMMERCE AND THE GENERAL ACCOUNTING OFFICE TO DISCUSS BLACK MARKETING IN KOREA AND ITS RELATIONSHIP TO OVERALL TRADE LIBERALIZATION IN THAT COUNTRY. I WILL COMMENT ON THE ADMINISTRATION'S EFFORTS IN OPENING THE KOREAN MARKET TO U.S. GOODS.

THE BLACK MARKET

THE KOREAN BLACK MARKET HAS BEEN IN EXISTENCE FOR SOME TIME. I AGREE WITH THE ASSESSMENT OF THE AMERICAN CHAMBER OF COMMERCE IN KOREA AND OTHER GOVERNMENT OFFICIALS THAT THE BLACK MARKET IS A RESULT OF KOREA'S RESTRICTIVE IMPORT PRACTICES. THE ITEMS THAT THE GAO HAS IDENTIFIED AS BEING A POPULAR ITEM ON THE BLACK MARKET ARE ITEMS WHICH ARE UNDER IMPORT RESTRICTIONS OR SUBJECT TO HIGH TARIFF AND TAXES, SUCH AS GROUND BEEF, WHISKEY AND CONSUMER APPLIANCES.

U.S. TRADE INITIATIVES HAVE BEEN SUCCESSFUL IN SIGNIFICANTLY REDUCING THE BLACK MARKET TRAFFIC IN SOME ITEMS. THE MOST VISIBLE EXAMPLE IS CIGARETTES, WHICH WAS A LARGE-SCALE BLACK MARKET GOOD UNTIL 1988. IN JULY OF 1988 OUR CIGARETTE AGREEMENT

WITH KOREA WENT INTO EFFECT, PERMITTING THE IMPORTATION OF CIGARETTES WITHOUT RESTRAINT. BLACK MARKET ACTIVITY IN THIS PRODUCT HAS DROPPED OFF SIGNIFICANTLY SINCE THEN. WE EXPECT OUR OTHER MARKET OPENING MEASURES TO HAVE A SIMILAR EFFECT ON THE BLACK MARKET. LET ME NOW TURN TO OUR TRADE INITIATIVES WITH KOREA.

RECENT ACCOMPLISHMENTS

THE BILATERAL TRADE AGENDA WITH KOREA HAS BEEN EXTREMELY ACTIVE IN THE PAST FOUR YEARS. SINCE 1986 WE HAVE REACHED A NUMBER OF AGREEMENTS WITH THE KOREAN GOVERNMENT INCLUDING: INSURANCE, INTELLECTUAL PROPERTY RIGHTS, CIGARETTES AND WINE.

LAST YEAR, AS A RESULT OF THE OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988, WE UNDERTOOK A NUMBER OF INITIATIVES TO FURTHER OPEN KOREA'S MARKET. THESE DISCUSSIONS RESULTED IN THREE AGREEMENTS. THE FIRST, ON INVESTMENT, COMPLETELY REVAMPED KOREA'S INVESTMENT REGIME. THE SECOND, ON LOCALIZATION, REMOVED A NUMBER OF NON-TARIFF BARRIERS TO U.S. PRODUCTS, INCLUDING PHARMACEUTICALS, COSMETICS AND MEDICAL AND ELECTRICAL EQUIPMENT. THE THIRD, ON AGRICULTURE, PROVIDED FOR LIBERALIZATION OF CERTAIN PRODUCTS OF INTEREST TO THE U.S. AND TARIFF REDUCTIONS ON PREVIOUSLY-LIBERALIZED PRODUCTS. IN ADDITION, THIS AGREEMENT DEALT WITH SEVERAL NON-TARIFF BARRIERS, SUCH AS THE BLENDING REQUIREMENT FOR

ORANGE JUICE AND PHYTO-SANITARY BARRIERS TO CERTAIN FRUITS, THAT HAVE BEEN HINDERING U.S. EXPORTS OF AGRICULTURAL PRODUCTS.

A FULL TRADE AGENDA

THESE ACHIEVEMENTS ARE SIGNIFICANT, BUT WE STILL HAVE AN AMBITIOUS AGENDA BEFORE US. KOREA WAS DESIGNATED IN FEBRUARY AS ONE OF THE COUNTRIES DENYING ADEQUATE MARKET ACCESS TO U.S. TELECOMMUNICATIONS EQUIPMENT AND SERVICES. WE WENT TO SEOUL IN SEPTEMBER TO DISCUSS THIS ISSUE, AND THE KOREANS ARE SENDING A DELEGATION TO WASHINGTON NEXT WEEK TO CONTINUE THE TALKS. WE EXPECT TO HAVE A FRAMEWORK AGREEMENT ON SERVICES, EQUIPMENT AND GOVERNMENT PROCUREMENT BY FEBRUARY OF 1990.

ON SEPTEMBER 28, AMBASSADOR HILLS MADE AN UNFAIRNESS DETERMINATION IN THE BEEF 301 INVESTIGATION AND FOUND KOREA TO BE IN VIOLATION OF A TRADE AGREEMENT. SHE FOUND RETALIATION TO BE APPROPRIATE, BUT DELAYED IMPLEMENTATION TO ALLOW TIME FOR THE GATT PROCESS TO WORK. WE WILL BEGIN RETALIATION PROCEEDINGS IN NOVEMBER IF THE KOREANS HAVE NOT ACCEPTED THE GATT BEEF PANEL REPORT.

WE ARE ALSO WORKING IN THE GATT TO REMOVE KOREA'S QUANTITATIVE RESTRICTIONS ON MANY OTHER AGRICULTURAL PRODUCTS. THE BALANCE OF PAYMENTS COMMITTEE OF THE GATT WILL BE MEETING NEXT WEEK TO DETERMINE IF KOREA HAS ANY BALANCE OF PAYMENTS JUSTIFICATION FOR

CONTINUING TO RESTRICT IMPORTS. WE AND OTHER DEVELOPED COUNTRIES WILL ARGUE STRONGLY THAT KOREA NO LONGER HAS A BALANCE OF PAYMENTS PROBLEM AND SHOULD, THEREFORE, COMMENCE PHASING OUT THESE RESTRICTIONS.

WE HAVE HAD A NUMBER OF DISCUSSIONS ON STEEL AND TEXTILES WITH THE KOREAN GOVERNMENT, AS WELL AS A SERIES OF DISCUSSIONS ON THEIR ENFORCEMENT OF INTELLECTUAL PROPERTY RIGHTS, OVER THE PAST FOUR MONTHS. WE HAVE REACHED AGREEMENT ON STEEL, BUT THE TEXTILE AND INTELLECTUAL PROPERTY DISCUSSIONS WILL CONTINUE.

CONCLUSIONS

DESPITE THESE ACHIEVEMENTS, WE ARE AWARE THAT KOREA'S MARKET IS NOT AS OPEN AS IT SHOULD BE, GIVEN KOREA'S LEVEL OF ECONOMIC DEVELOPMENT. THE FACT THAT CONSUMER DEMAND IN KOREA IS NOT BEING MET IS DEMONSTRATED BY THE ACTIVE BLACK MARKET. WE WILL CONTINUE TO WORK TOWARDS THE GOAL OF AN OPEN KOREAN MARKET FOR U.S. EXPORTS. I BELIEVE THAT WE WILL BE SUCCESSFUL, AND OUR SUCCESS WILL ELIMINATE THE NEED FOR A BLACK MARKET IN KOREA.

TESTIMONY OF SCOTT GODDIN
DIRECTOR, KOREA/TAIWAN DIVISION
INTERNATIONAL TRADE ADMINISTRATION
U.S. DEPARTMENT OF COMMERCE
BEFORE THE
SUBCOMMITTEE ON GOVERNMENT OVERSIGHT AND MANAGEMENT
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
OCTOBER 19, 1989

MR. CHAIRMAN, I AM PLEASED TO APPEAR BEFORE YOU AND THIS SUBCOMMITTEE TODAY WITH MY COLLEAGUES FROM THE DEPARTMENT OF DEFENSE, THE GENERAL ACCOUNTING OFFICE, AND THE OFFICE OF THE U.S. TRADE REPRESENTATIVE. I WILL COMMENT ON THE CHANGES IN KOREA'S OVERALL IMPORT REGIME, AS WELL AS ON THE CHANGES THAT WE EXPECT TO BE IMPLEMENTED IN THE COMING YEARS. I WILL ALSO DISCUSS KOREA'S SYSTEM OF TAXATION, AND HOW THIS SYSTEM EFFECTS IMPORTS OF U.S. PRODUCTS INTO KOREA.

RECENT PROGRESS

SINCE 1983, THE KOREAN GOVERNMENT HAS ELIMINATED A SIGNIFICANT NUMBER OF BARRIERS TO IMPORTS AND DIRECT INVESTMENT. LET ME TAKE A MOMENT TO DESCRIBE A FEW OF THE CHANGES THAT HAVE OCCURRED.

THE LEVEL OF IMPORT LIBERALIZATION HAS INCREASED DRAMATICALLY IN THE PAST SIX YEARS. KOREA HAS TRADITIONALLY USED RESTRICTIVE IMPORT LICENSING TO LIMIT ACCESS TO ITS MARKET. IN 1983, OVER 20 PERCENT OF THE PRODUCTS IDENTIFIED UNDER KOREA'S COMMODITY CLASSIFICATION SYSTEM, INCLUDING COMPUTERS, MACHINE TOOLS, CONSUMER APPLIANCES, COSMETICS AND MEDICAL EQUIPMENT, WERE VIRTUALLY BANNED FROM THE KOREAN MARKET. TODAY, ALMOST ALL MANUFACTURED GOODS ARE FREELY

IMPORTED INTO KOREA. LESS THAN FIVE PERCENT OF ALL PRODUCTS REMAIN RESTRICTED, AND MOST OF THESE ARE AGRICULTURAL PRODUCTS.

CONCURRENTLY WITH THE REMOVAL OF IMPORT LICENSING RESTRICTIONS, KOREA EMBARKED ON A PLAN TO REDUCE TARIFFS ON AN ANNUAL BASIS. THIS PROGRAM WILL CONTINUE THROUGH 1993, WHEN TARIFFS WILL REACH AN AVERAGE LEVEL OF 7 PERCENT, SIMILAR TO THE LEVEL IN MOST OECD COUNTRIES. FOR EXAMPLE:

PRODUCT	1984 TARIFF	1989 TARIFF	1993 TARIFF
MACHINE TOOLS	20%	15%	8%
REFRIGERATORS	40%	20%	8%
AUTOMOBILES	90%	25%	10%
BEER	100%	50%	30%
COSMETICS	50%	20%	8%

SPECIAL CONSUMPTION TAXES, LEVIED ON ALL LUXURY AND SOME CONSUMER GOODS, HAVE TRADITIONALLY SERVED AS AN ADDITIONAL BARRIER TO IMPORTS. THESE TAXES ARE APPLIED TO BOTH DOMESTIC AND IMPORTED PRODUCTS, BUT TEND TO RAISE THE PRICE OF IMPORTS PROPORTIONATELY MORE, DUE TO ASSESSMENT ON A HIGHER "IMPORT" PRICE, WHICH INCLUDES THE TARIFF. THESE TAXES WERE REDUCED IN 1988 TO STIMULATE CONSUMER DEMAND.

KOREA'S CURRENT IMPORT REGIME

DESPITE THIS PROGRESS, KOREA STILL MAINTAINS A RESTRICTIVE IMPORT REGIME FOR MANY PRODUCTS. ALTHOUGH MOST INDUSTRIAL PRODUCTS, INCLUDING LUXURY GOODS SUCH AS AUTOMOBILES AND WASHING MACHINES, ARE FREELY IMPORTED INTO KOREA, QUANTITATIVE RESTRICTIONS REMAIN IN PLACE ON OVER 200 AGRICULTURAL PRODUCTS, INCLUDING FRUITS, FISH PRODUCTS, VEGETABLES AND PROCESSED FOODS. TARIFF RATES IN KOREA RANGE FROM 8 PERCENT FOR RAW MATERIALS TO 15 PERCENT FOR MOST INDUSTRIAL PRODUCTS, WHILE AGRICULTURAL PRODUCTS STILL CARRY VERY HIGH TARIFFS OF BETWEEN 30 TO 50 PERCENT.

WITH THE REMOVAL OF TRADITIONAL BARRIERS SUCH AS TARIFFS AND IMPORT LICENSING, THE ATTENTION OF U.S. EXPORTERS AND THE U.S. GOVERNMENT IS BEGINNING TO FOCUS ON MORE SUBTLE TRADE BARRIERS. HIGH LUXURY TAXES, RESTRICTIVE IMPORT FINANCING PROCEDURES, CUMBERSOME AND RESTRICTIVE STANDARDS AND NON-TRANSPARENT CUSTOMS CLEARANCE PROCEDURES HAVE ALL BEEN THE SUBJECT OF INDUSTRY COMPLAINTS AND BILATERAL DISCUSSIONS IN RECENT MONTHS.

WE CONTINUE TO WORK WITH THE KOREAN GOVERNMENT TO REMOVE THESE BARRIERS. A TRADE AGREEMENT ON LOCALIZATION (IMPORT SUBSTITUTION) POLICIES AND STANDARDS, SIGNED LAST MAY, REMOVED A NUMBER OF NON-TRANSPARENT TRADE BARRIERS, INCLUDING THE AUTHORITY FOR THE

GOVERNMENT TO IMPOSE ARBITRARY BANS ON IMPORTED GOODS. WE HAVE SUBMITTED AN EXTENSIVE REQUEST LIST TO THE KOREAN GOVERNMENT IN THE URUGUAY ROUND NEGOTIATIONS FOR TARIFF REDUCTIONS. WE ARE ALSO SEEKING A SOLUTION, WITHIN THE GATT, TO KOREA'S REMAINING AGRICULTURAL RESTRICTIONS.

EXPECTED CHANGES

CONTINUED IMPORT LIBERALIZATION IN KOREA IS EXPECTED. A TARIFF REDUCTION PLAN IS ALREADY IN PLACE THROUGH 1993. IN 1989, THE KOREAN GOVERNMENT ACCELERATED A NUMBER OF TARIFF REDUCTIONS, AND A NUMBER OF AGREEMENTS SIGNED THIS YEAR, INCLUDING AGRICULTURE (KOREA AGREED TO REMOVE RESTRICTIONS ON 70 AGRICULTURAL AND FISHERY PRODUCTS OF INTEREST TO THE UNITED STATES), WINE, LOCALIZATION, AND INVESTMENT WILL REQUIRE EXTENSIVE LIBERALIZATION MEASURES TO BE TAKEN BETWEEN NOW AND 1993.

RELATIONSHIP TO THE BLACK MARKET

WE CONFIRM THAT GAO'S LIST OF ITEMS WHICH ARE DOING BRISK BUSINESS ON THE BLACK MARKET ARE THOSE WHICH ARE EITHER BANNED FROM THE KOREAN MARKET ENTIRELY OR CARRY HIGH TARIFF AND TAX BURDENS. MANY OF THE AGRICULTURE PRODUCTS ON THE GAO'S LIST ARE EITHER BANNED OR

SEVERELY RESTRICTED.

THE CONSUMER PRODUCTS ON THE LIST HAVE BEEN LIBERALIZED, BUT REMAIN SUBJECT TO HIGH TARIFFS AND TAXES. IN MY WRITTEN TESTIMONY, I HAVE INCLUDED A TABLE COMPARING THE WHOLESALE PRICE OF A DOMESTIC WASHING MACHINE AND AN IMPORT, ASSUMING THAT THE INITIAL EX-FACTORY AND LANDED COSTS ARE IDENTICAL. AS YOU CAN SEE, THE FINAL WHOLESALE PRICE OF THE IMPORTED MACHINE WILL BE APPROXIMATELY 20 PERCENT HIGHER THAN THE DOMESTIC PRODUCT. THIS CHANGE IS DUE ENTIRELY TO THE HIGH TARIFF, WHICH IS INCLUDED IN THE BASE PRICE FOR CALCULATION OF MANY OF THE SUBSEQUENT TAXES.

CONCLUSION

KOREA HAS TAKEN STEPS TO LIBERALIZE ITS IMPORT REGIME IN RECENT YEARS, HOWEVER, RESTRICTIONS REMAIN ON NUMEROUS PRODUCTS. KOREA'S BLACK MARKET INDICATES THAT U.S. PRODUCTS ARE IN DEMAND, BUT THIS DEMAND IS NOT BEING FULFILLED THROUGH THE EXISTING (TRADITIONAL) CHANNELS WHICH REMAIN SEVERELY RESTRICTED BY KOREA'S IMPORT POLICIES. OUR ONGOING MARKET ACCESS OBJECTIVES WILL CONTINUE TO BE DIRECTED TOWARD OPENING AND ASSURING LEGITIMATE MARKETING AND DISTRIBUTION OPPORTUNITIES FOR U.S. PRODUCTS.

TARIFFS AND TAXES ON WASHING MACHINES SOLD IN KOREA

	IMPORTED WASHING MACHINES		DOMESTIC WASHING MACHINES	
CIF		$300.00	DOMESTIC PRICE	300.00
TARIFF	20% X CIF	60.00		0
SPECIAL CONSUMPTION TAX (SCT)	28% (CIF + TARIFF)	100.80	28% OF PRICE	84.00
DEFENSE TAX 1	2.5% (CIF)	7.50		7.50
DEFENSE TAX 2	30% (SCT)	30.24	30% (SCT)	25.20
VAT	10% (CIF + TARIFF + SCT + DT 1 + DT2)	49.85	10% (PRICE + SCT + DT 1 + DT 2)	41.67
WHOLESALE PRICE		$548.39		$458.37

According to these figures, the wholesale price of an imported washing machine is approximately 20 percent higher than a domestically produced washing machine. This does not include any retail mark-ups.

JOHN GLENN, OHIO, CHAIRMAN

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United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

November 29, 1989

The Honorable Carla Hills
United States Trade Representative
Winder Building
600 Seventeenth Street, Northwest
Room 209
Washington, D.C. 20506

Dear Ambassador Hills:

The Senate Subcommittee on Oversight of Government Management appreciated the testimony of Assistant U.S. Trade Representative for Asia and the Pacific, Sandra Kristoff, at our October 19 hearing on the black market and South Korean trade practices. Thank you for permitting her to testify.

Ms. Kristoff admitted that "the black market is a result of South Korea's restrictive trade practices." She also stated that if the Subcommittee supplied your office with a list of popular black market items as identified by the General Accounting Office (GAO), USTR would inform the Subcommittee what action USTR has taken or will initiate on those items.

The following list of agricultural, consumer and high-value items were identified by the GAO as being popular on the black market: rice, oxtails, Spam, hot dogs, chicken, scotch whiskey, beer, wine, processed cheese, hair spray, shampoo, peanut butter, instant coffee, bananas, oranges and orange juice, canned and frozen fruit, frozen vegetables, chocolate, sports equipment such as bowling balls and golf clubs, washers, refrigerators, large-screen televisions and video cassette recorders. Please inform the Subcommittee as to the actions which have or will be taken by USTR concerning these items.

On another matter, the Department of Agriculture provided to the Subcommittee a written response from the agricultural attache at the U.S. Embassy in Seoul which stated that U.S. representatives "are not allowed to

bring up the black market at trade talks as an example of demand because it is technically our responsibility to police our commissaries." Ms. Kristoff testified that was not her understanding of our negotiating policy and that she would so notify the appropriate people. I think the black market is an excellent example -- living proof -- of the extent of the demand for U.S. products in South Korea, and we should be referring to it at every opportunity. Please provide the Subcommittee with confirmation that such notification has been made to key U.S. trade officials involved in South Korean matters.

Finally, in light of the information disclosed at the hearing, I have concluded that the Department of Defense should simply eliminate the ration control system currently in place and significantly reduce our enforcement efforts regarding the black market. To continue on as we are is to give ourselves a double whammy. We are spending taxpayer money to prosecute our GIs to control -- at the request of the South Koreans -- a black market that South Korea uses as a pressure valve to continue its restrictive trade practices against the importation of U.S. goods. That doesn't make sense. We shouldn't protect South Korea from a black market of their own making, particularly when protecting them hurts us in the long run.

Please respond to this request no later than December 11, 1989, and kindly address any inquiries about the preceding questions to Jack Mitchell of the Subcommittee staff at 224-3682. Thank you for your assistance in helping to address this important trade-related issue.

Sincerely yours,

Carl Levin

Carl Levin, Chairman
Subcommittee on Oversight of Government Management

CL:jhm

THE UNITED STATES TRADE REPRESENTATIVE
Executive Office of the President
Washington, D.C. 20506

The Honorable Carl Levin
Chairman
Subcommittee on Oversight
of Government Management
United States Senate
Washington, D.C. 20510-6250

Dear Mr. Chairman:

Thank you for your letter regarding the testimony before your Subcommittee of Sandra Kristoff, Assistant U.S. Trade Representative for Asia and the Pacific, on trade aspects of Korea's black market.

The attachment to this letter indicates the actions my office has taken or intends to initiate to obtain market access for each of the products identified by GAO as being popular on Korea's black market.

We are not sure of the genesis of the statement attributed to a U.S. Embassy official that U.S. representatives "are not allowed to bring up the black market at trade talks as an example of demand." In fact, we have consulted with Kevin McGuire, Economic Minister-Counsellor at the U.S. Embassy in Seoul, who indicated that the Embassy has from time to time used such sales as confirmation of popular desire for greater market liberalization and demand for U.S. products.

We take very seriously the problems faced by our exporters in Korea's market, and will continue to pursue market access for all U.S. products.

Sincerely,

Carla A. Hills

Enclosure

USTR ACTION TO OBTAIN MARKET ACCESS
FOR SELECTED U.S. PRODUCTS

Product	USTR Action
Rice Oxtails Processed Cheese Oranges Frozen Fruits Frozen Vegetables	We are trying to approach agricultural liberalization on a sectoral basis, rather than through a product-by-product approach. Korea has agreed to disinvoke its balance of payments justification for 274 products, 254 of which are agriculture or fisheries items. These items are expected to be covered by that liberalization, which must be accomplished in a balanced manner over the next seven years according to the terms of the Balance of Payments Committee Report. We intend to consult closely with the Koreans to insure that our concerns are addressed.
Spam	Liberalized in January 1987. Tariff is 30%.
Hot Dogs	The 1989 agriculture agreement requires this product to be liberalized by January 1, 1990.
Chicken	A number of categories of poultry will be liberalized as part of the 1989 agriculture agreement. We continue to seek liberalization of the rest of this category.
Peanut Butter	The 1989 Agriculture agreement requires the liberalization of this product effective July 1, 1989.
Instant Coffee	Luxury tax was reduced in 1988.
Bananas	Scheduled to be liberalized January 1, 1991.
Orange Juice	1989 localization agreement provided for an increased quota and a removal of the blending requirement.
Canned Fruit	USTR has successfully requested that certain canned fruits be liberalized. This has happened in the case of yellow peaches, fruit cocktail, and other canned fruits,

	which were all liberalized in January 1988. Canned pineapple will be liberalized effective January 1, 1990 and canned peaches will be liberalized by January 1, 1991.
Chocolate	Tariff reductions have been accelerated; labelling and freshness dating provisions were altered as part of the 1989 localization agreement.
Scotch Whiskey	1989 Localization Agreement requires complete liberalization of the whiskey market by January 1, 1990.
Beer	100 percent tariff reduced to 50 percent in 1989; scheduled to be further reduced to 30 percent by 1993.
Wine	1989 Section 301 Agreement requires complete liberalization of the wine market by January 1, 1990; removes other barriers to distribution and requires further tariff reductions.
Hair Spray Shampoo	As part of the 1989 localization agreement, the Korean government agreed to simplify the registration procedures for cosmetic and beauty products. These regulations are due to go into effect on March 1, 1990.
Sports Equipment	Luxury tax was reduced in 1988.
Washing Machines Refrigerators VCRs Large Screen TVs	Luxury taxes on these items were reduced in 1988. In addition, we are working with the ROKG to remove standards barriers to these products.